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PERSPECTIVES ON THE ECONOMIC IMPLICATIONS OF THE FEDERAL BUDGET DEFICIT

HEARING

BEFORE THE

SUBCOMMITTEE ON
ECONOMIC POLICY

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
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ON

EXAMINING THE ECONOMIC IMPLICATIONS OF THE FEDERAL BUDGET DEFICIT

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C O N T E N T S

WEDNESDAY, OCTOBER 5, 2011

PERSPECTIVES ON THE ECONOMIC IMPLICATIONS OF THE FEDERAL BUDGET DEFICIT

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U.S. SENATE,
SUBCOMMITTEE ON ECONOMIC POLICY,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 10:04 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Jon Tester, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN JON TESTER

Chairman TESTER. I want to call this hearing on the Economic Policy Subcommittee titled "Perspectives on the Economic Implications of the Federal Budget Deficit" to order.

We have got an esteemed panel of witnesses this morning, and I look forward to hearing their perspectives on the short- and long-term impacts of our Federal budget deficit. I am eager to hear about the impacts that our deficit has on economic growth, activities in capital markets, and investments.

One of the most important issues facing the Congress and facing our economy is the size and the scope of our deficit. It is a huge challenge and one that cannot be addressed by tinkering around the edges.

It is a tough challenge given how important it is to get our economy back on track right now. There is an urgency to addressing both the debt and the economy, and that is a difficult needle to thread.

I strongly supported the recommendations of the President's Commission on Fiscal Responsibility and Reform, and I appreciate all the good work and leadership that Senator Simpson and Erskine Bowles and many of my colleagues have shown in working with that Commission. Their work generated thoughtful bipartisan conversations in the Senate about how to address our deficit.

The bipartisan Gang of Six used this work to develop a framework to cut our deficit and cut spending. But, unfortunately, what most Americans saw this summer were not careful deliberations or solutions about how to address our deficit in a balanced and long-term way. What most folks saw was Washington at its worst: too much politics and very little in the way of responsible decision making; too many lines in the sand, not enough solutions.

Now, that is too bad because I do not think that accurately reflects the willingness of many Members of the Senate on both sides of the aisle and Members of this Committee to roll up their sleeves and make some difficult decisions necessary to address the deficit. A balanced, long-term approach to deficit reduction that keeps everything on the table is the only way that we are going to be able to address the deficit. That includes spending cuts, including defense, and tax and entitlement reform. And only those plans that are balanced and broad in size and scope have generated bipartisan support.

I am optimistic about the prospects for the Joint Select Committee and their ability to go beyond the $1.2 trillion minimum in deficit reduction required by the Budget Control Act. But this is not nearly enough to make a dent in our long-term debt. We can and should overachieve here. Failure to reach our target will lock us into mandatory indiscriminate cuts and will limit our options in the future, which will ultimately be devastating for this country.

But we can only overachieve if everything remains on the table. I do not think we can get there, at least where we need to get, without spending, taxes, and entitlements all being a part of the equation. And we need to make some tough decisions now so that we can take steps to address the economy so that we can continue to make the investment in things like infrastructure and education and research and development that are critical to economic growth and our ability to compete in this global economy.

There is a lot of uncertainty out there—corporate cash sitting on the sidelines, long-term investments that are not being made, and skilled people who are not being hired. And the longer that we kick the can down the road, the worse the situation is going to get. If we do not cut the debt in the short term, we will not provide any certainty for folks to move our economy forward.

At the same time, if we fail to create jobs quickly, the economy will not recover, and the deficit reduction that we need will not materialize. When it comes to growing our economy and cutting the debt, we cannot fail. It will not be easy. Every decision is going to be difficult, and it is going to be painful.

Today I hope we can examine the short- and long-term economic implications of the Federal deficits as well as the deficit reduction plans and their impacts on our economic growth, the appropriate dollar level of deficit reduction necessary to ensure long-term sustainability, and how we get a handle on the budget deficit right now while still continuing to grow the economy.

I look forward to hearing from all of our witnesses this morning. I want to thank them for being here. Unfortunately, Senator Vitter is going to be joining us just a little bit late this morning, so I want to turn to Senator Hagan to see if she has any comments she would like to make.

Senator HAGAN. Mr. Chairman, I appreciate you holding this session today, and I am looking forward to the witnesses' testimony.

Thank you.

Chairman TESTER. Thank you, Senator Hagan.

I want to welcome the witnesses, as I said earlier, a very distinguished panel. I want to thank them for their work that they have done in preparation for this Committee and their willingness to testify here this morning.

First we have Maya MacGuineas, who is the president of the Center for a Responsible Federal Budget and the director of the fiscal policy program at the New America Foundation. There she has focused on bringing accountability to the budget process. Ms. MacGuineas has also served as policy adviser to the Brookings Institution and has also worked on Wall Street. With that, I want to welcome Ms. MacGuineas.

Then we have the Honorable Roger Altman. Mr. Altman is the founder and chairman of Evercore Partners, an independent investment banking advisory firm, and has a distinguished career in Washington and in investment banking. Mr. Altman has served two tours of duty at the Treasury Department, serving most recently as Deputy Secretary of the Treasury during the Clinton administration.

And last but not least, Dr. Holtz-Eakin serves as president of the American Action Forum and has a long career as an academic and policy adviser, serving as Director of the Congressional Budget Office and as Chief Economist of the President's Council of Economic Advisers. In addition to his roles in Government, Mr. Holtz-Eakin has also served in a variety of roles at Washington-based think tanks as an economist and a professor.

I want to thank you all.

Unfortunately, our final witness, Mr. Bill Johnstone, is not going to be able to join us today. We will put his written testimony into the record.

With that, Ms. MacGuineas, please get us started. Just so you know, you have got 5 minutes. Your entire statement will be in the record, and if you could be as concise as possible, that will give us more time for questions. Thank you.

STATEMENT OF MAYA MACGUINEAS, PRESIDENT, CENTER FOR A RESPONSIBLE FEDERAL BUDGET

Ms. MACGUINEAS. Thank you. I will. Thank you to the Chairman and thank you to Senator Hagan, and it is a privilege to talk on this important topic and to speak as well with Roger Altman and Douglas Holtz-Eakin.

The country is now facing two major economic problems: first, our debt as a share of the economy is higher than it has ever been in the postwar period, and we are on track to continue adding to the debt indefinitely. In all likelihood, the debt is already a drag on economic growth. At the same time, we face serious economic challenges where the recovery has not taken off as well as we would have hoped, high levels of unemployment persist, and we have a number of structural economic problems from a skills shortage to underinvestment in critical areas and an abysmal Tax Code that is anticompetitive, too complicated, misallocates resources, and is harmful to economic growth.

So large deficits and debt have a number of negative economic effects. They harm the economy by diverting capital away from productive private investments. They drive up borrowing costs for families and businesses. That rates are currently so low is merely a reflection of the terrible situations around the world, and so as some of my colleagues say, being the best-looking horse in the glue factory is not a reason for relief, right? We have to make changes because of the economic problems that we currently face from our debt levels.

From a budgetary perspective, the high levels of debt lead to higher interest payments. That squeezes out other more important Government spending, and it leads to future tax increases. It also leaves us quite vulnerable to increases in interest rates, and CBO recently found that a 1-percent increase would lead to an addition of $1.3 trillion in interest payments over the decade.

High levels of debt lead to a loss of fiscal flexibility and the ability to respond to future crises. From an intergenerational perspective, of course, what it is is it is a result of us wanting to spend more, and we are unwilling to pay the bills. So we pass them along to the future generation, and that inequity is made worse by the fact that so much of what we are spending is consumption oriented. It is not even on the important investments that would help grow the economy and grow the future standard of living.

The uncertainty that comes for businesses and households from the high levels of debt is problematic because we know changes will have to be made, but we do not know what they will be. And that means that businesses, like you mentioned, are keeping cash on their balance sheets. They are not investing and creating jobs in a way that would be more beneficial for the economy in the short, medium, and long term.

And, finally, ultimately the unsustainable levels of debt can and will lead to a fiscal crisis if we do not make changes. And so something that was once unimaginable in this country is now a real possibility.

So we know what we need to do. We need to put in place a comprehensive, multiyear plan that would stabilize the debt at manageable levels and put it on a downward path so it is declining as a share of GDP. We should aim to bring the debt down to around 60 or 65 percent of GDP over the decade, still significantly higher than the historical averages of below 40 percent, but something that would be more manageable. And all areas of the budget have to be on the table.

So looking forward, our fiscal problems are driven by health care costs and the aging of the population. But given the commitment to phasing in changes gradually so people would have time to adjust, there is just no way to fix this problem without looking at all areas of the budget. And so rather than focusing on unrealistic promises about what we will not do, we should focus on how to reform the Tax Code in a way that raises revenues and grows the economy and focus on reforming entitlements in ways that protect those who depend on the programs the most.

So the debt threat is extremely serious, but I think it is also an opportunity to restructure the budget and tax system for the 21st century. By shifting our budget away from one that is directed toward consumption toward one that is directed toward investment, we can lay a new foundation for growth. And in order to be competitive down the road, we are going to have to focus on many of the areas that have not been invested in sufficiently while also reforming the Tax Code, all to be conducive with economic growth.

So debt reduction is not at odds with the growth strategy. In fact, I think it is the center of it. Putting in place a credible multiyear plan will have a number of immediate economic benefits.

First, it does reduce the pressure on interest rates, gives the Fed more room to maneuver, and it increases output over the decade. And if it is large enough, it eliminates the risk of a fiscal crisis.

Second, it frees up enough fiscal space up front to allow for more stimulus if that is determined to be the right course of action and for more space for the recovery to take hold.

Third, a multiyear plan will provide businesses and households more confidence and stability, allowing them to spend and invest in ways that will help the recovery and grow the economy.

Fourth, the added pressures on spending will hopefully lead to better oversight and more efficient allocation of resources.

Finally, a comprehensive plan, if it is large enough, will necessarily include tax reform and entitlement reform. And on the tax side, we should look to the Bowles-Simpson type of structure which broadens the base by reducing tax expenditures, lowers marginal rates, and raises revenues to help close the fiscal gap.

On the spending side, again, entitlement reform is the center of all of this, and it allows us to free up resources to both close the fiscal gap and direct more on public investments.

So, quickly, regarding the Super Committee, as it stands now, the new Joint Select Committee is tasked with saving $1.5 trillion, and this would be a tremendous accomplishment. However, unfortunately, it would not be sufficient to stabilize the debt. So, instead, the Super Committee should really consider going big, which would put in place a plan that is large enough to stabilize the debt and put it on a downward trajectory. And it should also think about how to go long, how to address the long-term drivers of the debt, and how to do it in ways that are smart so that they are conducive with economic growth—again, focusing on protecting public investments, reforming the Tax Code.

So just today JPMorgan released study talking about 10 reasons that markets are going to look at the effects of the Super Committee and its effects on growth, so we brought that study here for everybody to look at. Just to touch on a couple of the important key points it makes, the markets are looking for a downward debt trajectory, and that means the Super Committee is going to have to come up with something that is big enough to get that on track. They are worried that it is already harming growth.

We have been warned over and over again—and markets are aware of this—of the political polarization that is currently sort of dominating politics. There are concerns that global credit markets will turn, and this can happen on a dime, driving up interest rates here and harming the economy. And, finally, we could, in fact, lose our place as the reserve currency and all the advantages that that has with it. The ability to make changes on those terms is so much easier than it will be if some kind of crisis forces those changes.

So what we want to do is put in place a multiyear, credible plan that puts us on a glide path to stabilize the debt. To be credible, we should put that plan in quickly. It needs to be bipartisan, and it needs to come with triggers and caps both on spending and tax expenditures to keep the plan on track. And if we do that, I think the benefit of a large enough fiscal plan is that it both helps us with our debt challenges and our important economic growth challenges that we are currently facing.

Thanks for the opportunity to come today.

Chairman TESTER. Well, thank you, Maya. There will be questions as we move forward.

Next we will go to Roger Altman. Roger.

STATEMENT OF ROGER C. ALTMAN, CHAIRMAN, EVERCORE PARTNERS

Mr. ALTMAN. Thank you, Senator Tester, and thanks to the Members of this Committee for inviting me here today.

There are really two main points I want to make. One is that this is a moment of extraordinary economic and financial fragility. I think sometimes folks in Washington underestimate the degree of fragility that we are seeing right now. And, therefore, point two, the budget decisions which Members of this Committee, the full Congress, and the President will make over the short to medium term, especially through the Super Committee, will have a big impact on that fragility, either a positive impact in the sense of reassurance or, I fear, a negative impact if there is a failure at a time like this. And so my main message today is please keep in mind how fragile this environment is and how important those decisions are going to be from the point of view of that fragility. Now, let me just flesh that out a little bit.

From an economic point of view, I think it is pretty clear that the U.S. economy is on the edge of renewed recession. We might skate by with a little tiny bit of growth, or we might fall back into negative growth. And we are right on the edge of that. If you just look at the first half growth rate this year, it was eight-tenths of 1 percent. If you look at the forecasts for the rest of this year, and especially for next year—I have a lot of respect for the Goldman Sachs Economic Department. They just lowered their growth rate next to 0.5 percent. All these forecasts are coming down. We now see forecasts over the last 48 hours that Europe is likely to definitely fall into recession. And so we are in a real danger zone.

Then in terms of financial markets, it would be hard to put them or see them on more of a razor's edge. If you look at the yields, they are sending a profoundly negative signal. So the yield on 10-year Treasurys is roughly 1.8 percent. That is the lowest yield recorded since the Federal Reserve began publishing market data in 1953.

Now, yes, there are safe haven factors and, yes, of course, the Federal Reserve has got monetary policy on maximum ease. But that does not primarily explain it. That signal essentially says that the market is anticipating negligible demand for capital and negligible inflation. And those are hallmarks of recession. And then from an equity market point of view, we have seen the equity markets in this country decline 17 percent over the past 5 weeks. And it would just be difficult, as I said, to see a more delicate risky situation, and many of the elements of fear that we all saw in late 2008 and early 2009 unfortunately have reappeared. I do not want to say that we are back exactly to that point. We are not. But the fear factor, which was not around a couple of months ago, has crept back in, and this is a really worrisome and, as I say, fragile moment.

Now, turning to the deficit issues themselves, there is going to be tremendous attention, of course, on the Super Committee, and there are three possible outcomes there.

The first outcome, of course, is that the Committee fails to agree, does not submit recommendations to Congress, the trigger is pulled. Yes, there would be $1.2 trillion of 10-year deficit reduction that would result through the sequester, but the signal of failure at a moment of this fragility I think would be a very negative signal and really unhelpful from the point of view of just plain the economy and obviously the very difficult jobs picture that we are seeing and the possibility that the next move on unemployment rate up is up and not down. And most people think that is more likely than not that the rate goes higher than 9.1 rather than back down, and I do not know what it will be in the next couple of days but in general.

The second possible outcome, of course, is that the Committee does agree, sends its recommendations to Congress, which indeed passes them into law. That would be a very good thing.

And the third and best outcome is the one that Maya talked about, which is that actually the Committee decides to solve this problem once and for all. We need about $3 trillion of additional deficit reduction beyond the $1.2 to $1.5 that the Super Committee will look at or is looking at. It would be a good idea if that was done on a balanced basis, but it would be a really good idea if the Committee actually did go big and did go long, as Maya said. And, by the way, that would send a very positive signal to consumers, to businesses, and to financial markets.

I also want to say that it makes sense that there be a growth and jobs initiative over the short term just for the reasons of the fragility and the economic weakness that I talked about. The President, of course, has put forth a $447 billion program. I think myself it is a sound program. We all know the core of it is the payroll tax cut on an extended and deeper basis for employees and a payroll tax cut for small businesses at the employer level. But there are many variations on the theme of growth and jobs agenda. I think the important thing is that we actually take a step in that direction, obviously a temporary step, one that by its nature ends within a year, but trying to provide an insurance policy of sorts to this economy would be a sensible thing to do.

So please keep in mind how fragile and difficult this environment is and how relevant the budget decisions that you will be making over the short term are to either keeping us afloat or, unfortunately, putting us below water.

Thank you.

Chairman TESTER. Thank you, Roger. I appreciate your testimony.

Dr. Holtz-Eakin.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, PRESIDENT, AMERICAN ACTION FORUM

Mr. HOLTZ-EAKIN. Thank you, Chairman Tester and Senators Hagan and Bennet, for the opportunity to be here today. Obviously the outlook for the Federal debt is dangerous, and I have laid out some scenarios in my written testimony, and I think Maya and

Roger have been very clear about this so I will not belabor that point. It is imperative that we address this problem.

It is also imperative that we address the growth problem, and to the extent that there is a playbook that is available from looking at other countries' experience with the dual problems of slow growth and large debt, we have some lessons, and those lessons are that: you should cut spending, but not all spending is created equal; you should focus on cutting Government employment—not a big deal in the United States, we do not have massive amounts of people on Government payrolls—and transfer programs; and you should preserve spending on the core functions of Government: national defense, infrastructure, basic research, education. And so cutting spending and doing it right is element number one; number two, keep taxes low and reform them to be pro-growth, and what is heartening about that is that is my reading of essentially what the Bowles-Simpson Commission said. They said this is a national moment of truth, we have to do something. Our problem is spending, and it is all spending, so each side of the aisle needs to understand that some of the things they love dearly are subject to some cuts. And if you are going to look at revenues, you have to do tax reform, and I thought that was a tremendous message to come out of the Committee.

Going forward, it is clear that we have to address first and foremost the entitlement programs. These are the core of our social safety net, and they are actually badly broken. Social Security is running red ink right now. That red ink will increase in the years to come. And absent changes, every retiree will face a 23-percent across-the-board cut in 2037 or so. It is not a good service to have a core part of the retirement system falling apart before our eyes and not fixing it. Medicare right now has a gap between payroll taxes in and premiums paid and spending going out of $280 billion a year. It is an enormous fiscal cancer, and going forward it will only get worse.

Medicaid is essentially all deficit financed at the moment, and it is not an outstanding program. Medicaid beneficiaries regularly have difficulty finding primary care physicians. They are more likely to get ordinary care in emergency room settings.

I think as a matter of good social policy, these programs deserve to be reformed. As a matter of budget policy, it is imperative that they be reformed. As a matter of avoiding what has been called by Erskine Bowles "the most predictable crisis in history," we should do it and do it quickly. And so that should be the focus of attention.

I know there are concerns about cutting spending. I want to say a couple things about them.

Number one, everyone should think of reforms that cut spending as reductions in future taxes. If you spend the money, you are going to have to pay for it one way or another. And so every time we take a dramatic step to control those outlays, we are actually controlling the future tax burden. That will improve the business climate immediately, and it will be something that I think will serve this country well over the long term.

The second is I am concerned that fears about cutting spending harming the economic recovery are being used as an excuse to stall efforts to fix our budget problems. You know, I would just say this lovingly. I have watched Congress a long time as the CBO Director. I have never seen the Congress cut enough to endanger any recovery. And that is a problem I want to have, and I will be happy to weigh in when I see it happening.

Much has been said about the budget ceiling debate and the efforts that came out of that, but if you would think about it, that is a promise, honest, really, that a future Congress in 2018 will spend a lot less than it might otherwise have. But we have not actually cut anything yet, and so I would like to be surprised at the aggressiveness of the cutting to come out of this Congress because we need to get this done.

The next thing I would say is that it is not just cutting. Especially in light of the Joint Select Committee, "cutting" is the wrong word. If we simply starve money out of Medicare or starve money out of Social Security without reforming those programs, we will not have solved the basic architectural problems that led us to where we are. And so think about this as an opportunity for reform. That means lower future taxes, and I think we can do it without impeding the recovery. Indeed, I believe it will help.

And move fast. I think, you know, the evidence is in that we are in the danger zone already. The probability of crisis is high. Maya stole my line about being the best-looking horse in the glue factory, but I will find another one.

And remember that we also have the other characteristics of countries to get in trouble. We have an enormous reliance on short-term borrowing. We have a lot of not well understood and not easy to value liabilities that pop up in State and local pensions and still out of the housing sector, and those are exactly the kinds of characteristics of countries that think, "We are fine," but then end up having a quick reversal in financial markets. So I do not think we should do that.

And the last thing is there is a lesson about the fragility and the fear that came out of the debt ceiling debate. My view is the debt ceiling debate had a lot of politics as usual, for better or for worse. I mean, these are difficult things to do. Raising the debt ceiling is not a happy moment for any Congress. The difference this time was that something actually had to get done. Underneath the debt ceiling debate was a real debt problem, and the sooner we fix the debt problem, the sooner we undertake the steps necessary, the less the kind of political bickering that comes over raising the debt ceiling will actually scare financial markets, because we will have solved the problem and moved it back to just dealing with the Nation's mechanics of finance.

I thank you for the opportunity to be here and look forward to your questions.

Chairman TESTER. I thank you all for your testimony, and we will start out. We have been joined by Senator Johanns and Senator Bennet before that. I will start, and I think 7-minute rounds if that is OK with the Members of the Committee.

I just want to go back briefly and this is a question of all of you about the balanced approach to addressing our deficit. We have two realities out there. We have got the political reality and we have got economic realities, and sometimes they seem to clash. They should not but sometimes they do.

So, given these realities, what is the appropriate dollar amount or range that we should be looking for? I know some of you talked about big ones but I mean a bigger one which by the way I agree with. But if we are going to change the trajectory of our deficit, what would you say is the number that we need to be looking at to come out of the Super Committee at a minimum?

Ms. MACGUINEAS. Well, of course, whenever you are talking about saving numbers there is always plenty of room for gimmickry because of baselines, because the question is always saving compared to what.

But so, I think the most useful number basically to look at where you are going to have your debt by the end of the decade and whether it is going to be moving up or down as a share of the economy.

So, you basically want to have the debt in the range of 60 to 65 percent of GDP after a 10-year period and moving down. Compared to a realistic baseline which assumes things like ongoing patches of the AMT, SGR, extension of part but not all of the tax cuts that were in place or revenue levels at that level that you compare to, I think the best thing to shoot for is about $4 trillion in savings. $3 to 5 trillion might be an appropriate range. We have already put 1 trillion of savings in place because of the caps we have already accomplished.

Now, we have recently held a forum where a number of voices from all sides of the political aisle and all different backgrounds came forth and sort of made a call for go big, and there were some people who said we should be thinking about two to three times as much as that so 10 trillion.

That to me would be great in terms of how much debt we are going to be adding over the next decade but it is unachievable. And I think it is really important that we put down a marker that is achievable but pushes us to get enough done that we can reassure credit markets, rating agencies, businesses.

And so my best estimate will be if you can do 3 trillion on top of what we have already done that would really get us in the range where we bought ourselves some time.

Chairman TESTER. Roger.

Mr. ALTMAN. I agree with the numbers Maya just used and they are in my own testimony. But to complement what she just said and echoing what I tried to say myself earlier, I think it is really important that the Congress and the President show that they can make steady progress on this problem and that, to some degree, the fact of progress and that it is on a sufficient trajectory so that we are meaningfully eating into this deficit overhang and debt overhang is more important than the precise amount, particularly in the context of the fragility that I talked about.

So, as Maya said, there was a trillion or 917 billion agreed in the context of the debt limit process. There is another at least 1.2 trillion as we all know in terms of the sequester amount or the trigger that would occur underneath the Super Committee. So, you have 2 trillion, assuming that the Congress ultimately sticks with it in future years.

And that is a good start. It is not enough because then there would be at least another 2 trillion needed. But the fact of progress, in my judgment, is more important than the precise amount because the need now is to reassure consumers, households, let alone businesses and the financial markets, that our country can actually, seriously address this.

And I think at the moment I think most of the Members of this Committee would agree, there is great doubt about that coming out of the difficult process to put it charitably that we saw on the debt limit.

Chairman TESTER. Dr. Holtz-Eakin.

Mr. HOLTZ-EAKIN. I will not agree with the numbers but I really want to echo Roger's point about extending the confidence of markets and the United State's ability to handle its affairs.

So, I think quality over numerical targets is an imperative. The best example of that is Social Security reform. If we were to do any of the bipartisan Social Security reforms that have been proposed over the past couple of years, we would solve what I think is a very important part or social safety net.

We would send the signal to world capital markets that we can touch what has traditionally been the third rail of U.S. politics in a sensible way.

We would do very little actually over the next 10 years in terms of deficit reduction. It is a relatively modest impact because we do not hit any current retirees and those near retirement in most of those reforms.

I still think that would be an enormously beneficial step. It would also allay a lot of the fears that some people have about cutting spending as we struggle through this recovery because all of those impacts are in the future.

So, that I view as a very high quality reform, and the more we do of things like that I think the more confidence we will instill in capital markets and we will actually address our long-term debt problems and that is the kind of progress I think we would benefit the most from.

Chairman TESTER. OK. Just kind of a follow-up, and we will start with you, Roger, because this is for all of you.

Is it possible to hit the kind of targets that you guys are talking about the 3 to 5 trillion which is pretty much what I heard without including everything that is out there, without including the entitlements that Dr. Eakin talked about, without including reductions in defense spending, without including tax reform, you know, all of them?

Mr. ALTMAN. Mr. Chairman, the short answer is no. It is theoretically possible, of course, to try to solve this problem, for example, entirely on the spending side. But for example, the impact on national security and defense spending particularly probably would be unacceptable.

It is possible, of course, to imagine gigantic revenue increases but those would likely have a negative economic effect and worsen some of the problems we have discussed here before.

So, the most sensible approach and really the only one in practice that would work is a balanced one, balanced in the sense that entitlements, of course, are center stage, revenues play a role, and the like.

So, I think the answer to your question, sir, is no, it is not possible to do it except with all in.

Chairman TESTER. Doctor.

Mr. HOLTZ-EAKIN. The short answer is I concur, I mean, that you really have to look at everything, and we have big problems everywhere you look.

Chairman TESTER. Maya.

Ms. MACGUINEAS. Sure, you can do it all on the spending side but there is not a single person who would actually be willing to when you went through the exercise of what it would take.

And one of the reasons is a very sensible one, that the core of any reform plan is going to have to be reforming entitlements but those are things that we are going to do gradually and we are not going to suddenly raise the retirement age starting tomorrow. We are going to phase it in at a very slow pace so that people have time to plan and adjust. The same with the scaling back of benefits which I presume would be targeted more at people who do not need them in order to protect them for people who do.

So, when you are talking about changes that you phase-in gradually that makes it basically impossible to do this without looking at all areas of the budget.

I also think from a political perspective everybody needs to be in on feeling like this is shared in a way that is fair, and one of the things that Erskine Bowles and Al Simpson found when they did their commission was that the bigger they went the more people bought in and the more support they got because everybody felt like they were part of the overall package and it became big enough to actually create a win.

So, when we talk about whether the Super Committee should go big or small, one of the benefits other than being economically beneficial in solving the problem is that politically the rewarded is you solve the problem rather than the headlines the next day after you have gone through all this hard work of saving a trillion and a half being, well, there is still so much more to do. So, there is political upside in putting everything on the table and building a big enough package.

Chairman TESTER. Absolutely,

Ranking Member Vitter.

Senator VITTER. Thank you, Mr. Chairman, and thanks to all of our witnesses. I would like to ask each of you what would you rate as the chances of further formal downgrades of U.S. credit if, A, the Super Committee is not successful and the sequestration happens or, B, it is successful only to its minimum dollar figure mandate level?

Mr. HOLTZ-EAKIN. In, A, I think the probability of downgrade is one. If we continue to fail, we will convince capital markets that we are not going to address

Senator VITTER. It would be 100 percent.

Mr. HOLTZ-EAKIN. Yes, 100 percent.

The second one is harder because how it hits the spending limit matters. And as I said before, if we were, for example, to do a Social Security reform which would be budgetarily modest but have enormous confidence effects I think, you know, we can avoid things like that.

Mr. ALTMAN. Senator, I have a slightly different view. I do not think the chances of a downgrade in the event that the Super Committee fails to agree or that the Congress does not pass its recommendation is 100 percent because after all there will be at least 1.2 trillion of deficit reduction then triggered over 10 years, again provided the Congress ultimately sticks with that.

So, I think the chances of downgrade under that scenario from another agency, remember there are several agencies and only one of them so far, Standard and Poor's, has acted on the negative side, are probably 50–50 because even if the Super Committee fails, we will have set in motion over the past few months 2 trillion of deficit reduction against a problem that is $3 to 5 trillion in size, probably closer to the high end.

But I think the psychology again of the Super Committee failing is the problem. In other words, the signal that just like the debt limit process showed us not in the most favorable light a failure of the Super Committee would send a negative psychological signal.

And what often happens, and I will stop on this note, what happens is rating agencies follow markets not so much as lead them, and if the market sentiment in general is very negative and the sense in the markets, and this time you might see it expressed more in the equity markets than the bond markets, the sense is the reaction to the failure of the Super Committee is very negative at a time when, as I said before, everything is so fragile.

That would be then pressure in effect on one of those agencies or more than one to take a negative step. So, I think it is only 50–50 but I think the problem is the psychology rather than the substance.

Ms. MACGUINEAS. I would say that the hard truth is that S&P was probably correct for downgrading us when they did in that we had not set ourselves on a course to do what we all know needs to be done and I think now there is another kind of moment of truth which is what will come out of the Super Committee.

If they fail completely, I think it is likely that we will have a downgrade pretty quickly. If they come up with what their mandate charges, the 1.2, I think Doug has made the really important point that it kind of depends what the make up of that is.

So, keep in mind the economy is going to be worse than most of the projections have been assuming. We have already seen that just a 1-percentage increase in interest rates would add 1.3 trillion to the deficits from increased interest payments alone over the next decade.

So, saving 1.2 in and of itself is not going to be much of a debt in the challenges that we have. The only way that I think that would be reassuring is if what makes that up are the critical problems driving the debt.

So, if that 1.2 trillion, if the Super Committee accomplished just the minimum it is supposed to focused on health care or accomplished making Social Security solvent for the long run or made real progress on tax reform and improving tax expenditures, that could be reassuring.

But if it focuses just on the low hanging fruit, and we need to reform agriculture subsidies and public pensions and all those things but that is not a package that would reassure credit markets or rating agencies on its own.

So, if we go big, I think we will not be downgrade because we will have put the debt on a stabilized path. If we go medium, I think it depends on what is in that package.

Senator VITTER. If I could react to some of your answers. I agree with your answers. However, I believe if the Super Committee hits the minimum target only, they are going to be doing that by going after the low hanging fruit, not going after any bigger issues.

If they are going after bigger issues, they can easily go well above that number. I do not think that scenario is likely.

And, Mr. Altman, I just say in terms of sequestration, I think the day after the Super Committee fails, there is going to be plenty of evidence that that will not hold for any significant period of time, to sort of follow up on your comment there.

Second and final question. Give us a ballpark figure in your opinion of what fundamental tax reform, broadening the base, lowering rates, what revenue it could raise if it is done on a revenue neutral basis, in a static model what revenue could it produce on a dynamics score?

Ms. MACGUINEAS. I would estimate depending on the parameters of the tax reform that you would probably be in the neighborhood of raising $848 billion from something that is revenue neutral on a static basis if you look at the dynamic effects, and of course, the form of the corporate reforms would be critically important in that as well.

Mr. ALTMAN. I generally agree with that. I think the formula that was used by Bowles-Simpson which is essentially a three to one formula in terms of spending versus revenues with one of the three being the interest savings is a very good framework.

And obviously under Bowles-Simpson they envisioned about a billion dollars of revenue impact.

So, the figure Maya used or a slightly higher figure would be my answer, Senator.

Senator VITTER. Just to be clear, that model is a little different than what I set out. What I set out is revenue neutral and a static model. Theirs was not. So, if you are talking about something revenue neutral and a static model, would you agree with 800 billion?

Mr. ALTMAN. Yes, sir.

Mr. HOLTZ-EAKIN. So, I would put it in the range of 700 to a trillion over 10 years. The wildcard being how you do the international tax reforms. If we were successful in getting the corporate rate down to an internationally competitive level and moving to a territorial tax system, moving away from worldwide taxation, there are many ways to do that.

But if we do it the way I would prefer and make the U.S. an advantageous place to locate future investments, you can get much bigger near-term impacts out of international capital flows and FDI in the U.S. than you would otherwise. So, you can hit all sides of that range depending on how you structure the revenue neutral piece of the reform.

Senator VITTER. Thank you.

Ms. MACGUINEAS. I have one quick point which is when we are thinking about that and obviously at least the number I put out was not precise. It is sort of my best guess.

But there is also revenue advantages that will come from having an overall debt consolidation package. So, you are going to have revenue increases from pro-growth tax reform but you are also going to have revenue increases from the medium- and long-term effects of a debt consolidation package which you might want to think about looking at as well.

Chairman TESTER. Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman, and I want to thank you for holding a hearing on this vital topic, and we have not spent enough time on this and talking about it, and I appreciate your letting me sit in on the Subcommittee.

Mr. Altman, I share your concern about the fragility of this economy. I think it is in much tougher shape than we seem to imagine here in Washington. I see it every single day when I am home in Colorado. The effects of two decades of declining family median income has hit the people in my State very, very hard.

I was struck the other day by a *Wall Street Journal* piece on the front page about Procter and Gamble, the most iconic middle class brand I can imagine and how they are adapting their business strategy to reflect the decline of the middle class by selling to the richest Americans and the poorest Americans because that is where the growth is.

That is what this is really about I think. I mean we talk about deficit and debt and all of the rest. The fact is our economy is in very, very tough shape and our families are in tough shape as result.

There is $2.3 trillion of cash sitting on the balance sheets of America's corporations. It is not being invested in the economy to grow jobs. I think a huge part of that is, Mr. Chairman, that people do not know what interest rate environment they are going to be in because we do not know what we were going to do.

In that spirit, I wanted to ask you about what you think the effect of the debt ceiling conversation was on economic confidence in the markets in this country, because we went through an entire summer of what was in many ways I think a disgraceful conversation.

My sense was that the economy was beginning to move forward but, to show you my bias, that conversation or the lack of a real conversation has contributed mightily to the lack of confidence people have in the economy.

Can you talk a little more about that?

Mr. ALTMAN. I think the answer is profoundly negative because the signal that was sent to consumers, households, businesses was dysfunction. And anytime you are looking at economic outlooks, unemployment outlooks, confidence plays an important role and we are all seeing surveys which show that consumer confidence at 20, 30, 40 year lows.

Just from my other life, I can tell you that business confidence is quite weak, and the debt limit process or lack of process played an important role in that.

I would also like to digress and say in spirit of your opening comments, I do not think enough attention is played to what the real conditions are in the labor market.

So, everybody pays attention to the unemployment rate but, as Doug points out in his testimony and I point out in mine, the labor conditions are actually worse than that. The underemployment rate which is probably better measure because it captures people who have given up looking for work and it captures people who are working part time who would rather work full time at 16.2 percent and the labor participation rate which is the most basic of all, just the percentage of working age adults who have a job is at a 27-year low of 64 percent.

And then we all saw the poverty data although it seemed to come and go with no attention at all but it was pretty devastating, 45.3 million Americans in poverty, 15.3 percent of the population, the worst figures in about 20 years, obviously affected by the economic conditions.

So, again, this is a moment of great risk. We are really close to slipping back into negative territory.

Senator BENNET. In that spirit, I mean, a fifth of the children in this country are living in poverty, a 43 percent increase in the poverty rate in the last decade, and an economy where the productivity index continues to rise and rise and rise.

We have a very productive economy but we do not have an economy that is creating jobs for people in the country.

In that spirit, I want to ask you, Mr. Holtz-Eakin or any of the panelists, that $4 trillion number sounds large over a 10-year period. But I wonder if you could give us a perspective on our run rate about how big that really is, because as somebody who has spent time in business and in local government and who has had to make tough budget decisions over time, on a percentage basis in the face of all the things that we are talking about, it is really not that huge a number, is it?

Mr. HOLTZ-EAKIN. In a $15 trillion economy. So if you did 4 trillion this year, you would be under 33 percent. If you do it over 10 years, 3 to 4 percent. That is where we are.

The magnitudes, however, can be staggering. If you do the arithmetic, we are borrowing $58,000 every second, more than the median family income in the United States every second we are burning it up. So, there is a real need to change this trajectory and do it in a significant way.

Senator BENNET. My hope, Mr. Chairman, is that we can get past what is a political problem in Washington, DC, and create a path out of the situation that we are in that is not remotely as hard as what people in our States are having to deal with every single day.

So, I thank the panelists for their testimony. I thank you for the hearing.

Chairman TESTER. Thank you for your kind words and thanks for your questions.

Senator Johanns.

Senator JOHANNS. Thank you, Mr. Chairman, and to all the witnesses, thanks for being here.

All of us over the past years have participated in hearings like this. We have sat in each other's offices talking about this problem remarkably defining the problems pretty straightforward.

The difficulty is how to go from definition of the problem to something that starts putting solutions in place.

All of you have more Washington experience than I do. But it seems like we can all go to the floor no matter which side of the aisle we are on, give a great speech about how significant the problem is.

Give us some advice on how best to solve this, and here is what I have in mind when I ask that question just to give you a fair notion of what I am thinking about.

You have this deficit group. They came up with a recommendation. You have the gang of six, a remarkably similar recommendation came out of that effort.

I think these are two very workable approaches. I am not saying I embrace them 100 percent. But they seem to be workable and yet they do not seem to be going anywhere at the moment.

My worry is that we are going to do a trillion two. Everybody is going to breathe a sigh of relief. We are going to turn the calendar over into a Presidential election cycle. It will be much easier not to deal with this than to deal with it, and now another year slips by and the problem only gets worse.

So, you are not going to offend anybody on this panel. Tell us what we are doing wrong and how do we overcome that and start solving this Nation's problems?

Roger, can I start with you?

Mr. ALTMAN. Well, I want to echo in response to that very good question, Senator, what Maya said. I think the process which the Simpson-Bowles group went through provides a bit of a roadmap toward the right outcome here or actually a solution.

Because it was, because they sought a total solution, because it was a very well run and deliberative and careful process, and because the ultimate recommendations at least from the cochairs were widely seen as fair and relatively conservative apropos of this 3 to 1 ratio I mentioned before, they achieved at least a modestly bipartisan result.

We all know the Members of the Committee from both sides who voted for the cochairs' recommendations.

So, I think that is the best guide to how to solve this. As Maya said, the greater degree to which you work on a one-step, full solution, a full solution, so that we are dealing with another 3 to 4 trillion beyond the 917 originally set in motion under the debt limit process, I think the better chances of success, the higher the chances of success.

I just cannot think of a better blueprint than the one that the Bowles-Simpson group laid out. Is it perfect? No, of course, it is not perfect.

But it had wide appeal and, for example, I happened—my private life involves working with the business community and there is enormous support for the business community in that framework.

And no one has any problem, I do not mean no human being, but by and large, no one has any problem with the ratios they used, the size that they wanted to go for, and if you put that to a vote at the Business Roundtable or the Business Council or any such group it would pass overwhelmingly.

That does not mean it is the right thing, but just as an example.

Senator JOHANNS. Maya.

Ms. MACGUINEAS. So, I have to say that I know it is pretty easy to sit here on the sidelines and say we need to do it. We all know what the answer is. You just have to do it.

And I think looking at what the members of Bowles-Simpson did and the gang of six did, it is truly inspiring because we have had a decade of nobody confronting the really tough choices involved in fixing the fiscal problems.

And in the past year that has changed. The dynamic has changed and people have come out and started talking about realistically what is going to be involved, and I think we are moving in the right direction.

I do not think time is on our side but I think we are moving in the right direction. And a lot of people sitting in this room right now are critical in that, and it really is terrific.

So, it is frustrating because we know what it is going to take and we also know that nobody is going to get their first choice.

The past couple of years were for people putting ideas out there, and there are a number of ideas now. We, in fact, have kind of this comparison table that shows all the different policy plans that have been recommended, and all the overlap. There is tremendous overlap.

And it is now the point to say nobody is going to get their first choice and it is time to start compromising.

So, I think the thing you do is you agree on the fiscal goal. Let us say that is to save 4 trillion totally, and stabilize the debt.

You run through a couple of scenarios. Let us just look at what it takes to do that on the spending side. OK. It turns out that realistically that is just not politically acceptable for anybody no matter what party.

Let us look at what it takes to do that primarily on the revenue side or even 50–50, and it actually is so harmful for growth and is not really practical.

We know the ratios of Bowles-Simpson are the right place to start, and we know that that is terrific. My specific recommendations would be take Bowles-Simpson and put in a little bit more on health care reform.

I think if there is one place we need to go is to do more on health care. I think that would have helped buy a few more people into the entire process of being structurally sustainable, and I think you have a great working document to start with right there.

And my final point would be Prospect Theory says that you should give bad news all of once. Get it over with. So, if you are going to come up with a fiscal package, let us just fix the problem. If you are giving good news, do it in lots of little bits.

But this is tough stuff. So, we do not want to have to keep coming back and making these hard choices. So, we should go as big as we can and use something Bowles-Simpson to get us started.

Mr. HOLTZ-EAKIN. I want to echo the proviso that I am a little uncomfortable giving cheap advice from the easy side of the table. I have been in the position of doing that for a number of years.

What you are asking is actually quite hard. But, you know, I think both Roger and Maya are right about Bowles-Simpson. That is the politically tested architecture that was much more successful than anyone really dreamed it would be, and it gives you the components on spending and tax reform that are going to be elements of success. So on the politics, I think that is right.

On the second piece, which is the substance, how to really be successful, I would urge everyone to really change real programs, which dominates, in my view, tremendously what we have done so far, as it processes, promises on caps in the future, sequesters that are more reneged upon than honored in the history of budget by the Congress. And so we have really got to change the program so that it is far more convincing. And in doing that, you know, these tough issues of taxes and spending, I think we have to somehow overcome what has been a recent—I do not know what the very word is—a recent viewpoint where principle compromise is not possible, it is always viewed as surrender.

It is important to recognize that—you may not think it is fair to have your program cut, I might not think it is fair to have my taxes increased. But both of those are dwarfed by how unfair it will be to leave this problem unfixed and ask the next generation to do both those things in the presence of a broken economy because we did not do our job. You know, that is where we are, and somehow we have to rediscover that spirit and understand that that is what is at stake.

Senator JOHANNS. Thank you, Mr. Chairman.

Chairman TESTER. Thank you for your answer to the question. Before we go to Senator Hagan, I would just say, sitting on this side of the table, I will tell you that I think there is a realization by everybody up here and a whole lot of folks in the Senate that tough decisions are going to have to be made, or as every one of you pointed out, things are going to get a hell of a lot worse.

Senator Hagan.

Senator HAGAN. Thank you, Mr. Chairman, and once again, thank you so much for holding this session, and for our witnesses, your testimony is certainly stark, realistic opinions and facts, and I am hoping that everybody can listen to what you are saying and realize that we do have to take action. And I have always said that I have been a strong supporter of the Bowles-Simpson report and a strong supporter of the Gang of Six, and I am certainly am hoping that the Super Committee goes big, goes long, and goes smart.

Dr. Holtz-Eakin, I have been looking at a number of measures that might be used to get the economy growing again, and one measure that I know that has bipartisan support is to allow companies with earnings trapped abroad to bring that money back to the United States at a temporarily reduced tax rate. I know you have done a lot of work on this issue. Can you talk about some of the economic benefits of what this measure might mean?

Mr. HOLTZ-EAKIN. Well, as you know, I have done some work on this, and I think that Roger is right about how fragile the economy is. I think we need to do things that boost the near-term growth rate for sure. I also think we ought to do things that are consistent with the long-term path we want to end up on. And in my view, we should end up with a territorial tax system with zero taxes on repatriations and a much lower rate overall. This moves in that direction.

I think that if you do a fair reading of the research literature—and the most important thing about a fair reading is you focus not just on the companies that in the past have repatriated profits, because the mistake that literature makes is if a company brings some money back and repurchases shares, they then pretend that money is going into a black hole. It did not. It went into the economy, and a correct reading is what is the overall impact of bringing those dollars back on the economy, not on those companies. I think it would have very beneficial impacts. It is the same kind of economic impacts as the President's stimulus bill was modeled on. If you use those kinds of estimates, you get, you know, $360 billion in additional GDP from a sort of stylized repatriation policy.

So I certainly think it cannot hurt to bring the money here instead of leaving it overseas, and it is the kind of thing we ought to do and do quickly.

Senator HAGAN. Thank you.

Mr. ALTMAN. Senator, could I comment for a second on that?

Senator HAGAN. Yes, please.

Mr. ALTMAN. I would just add two provisos. One is there is a pretty good argument for there being some *quid pro quo* associated with repatriation, because we all can look at the amounts of cash—Senator Tester referred to that—that corporations have already here in this country on their balance sheets and extrapolate that the likely result of that repatriation would not necessarily be any positive impact on, for example, hiring or investment, at least over the short term, which is when we need it. So there are various ways to think of *quid pro quos,* but if it were left up to me, I would want a repatriation plan which was tied to some positive economic impact rather than just a blanket one.

And the second proviso is I am a little concerned that we may need repatriation to facilitate tax reform, and we al know that tax reform is going to be necessary in the context of deficit reduction and, more broadly necessary for competitiveness. So I wonder if that should not be an element in broad-based tax reform rather than a separate step all unto itself.

Senator HAGAN. Well, I think we do need broad-based tax reform, but I also think we need to look at what is happening right now and what we can do to make an impact. But I do appreciate the comments, too, on how we can structure something to be sure that it does have more of an economic impact on jobs.

The debt-to-GDP ratio is often cited as a sign of fiscal health. I would welcome your comments on what ratio of debt to GDP you think would trigger increases in the interest we pay on our debt. Anybody on the panel.

Mr. HOLTZ-EAKIN. I think that it is just not possible to draw a statistical line and say on this side credit markets will trust you, on that side they will not. It is really about their perception of the U.S. future and will we be able to get what is clearly an unsustainable trajectory back on track. And when the confidence that we can do that goes away, the interest rates rise inevitably. That is when you see a rush for the exits and real financial market turbulence.

So we do not know the number, but we do know that if you use history as a guide, we are in the danger zone. We already debt-to-GDP ratios which historically have been associated with slower growth, high probability of sovereign debt crisis, and we should not pretend that we have any luxury of additional increases. We should go the other direction fast.

Ms. MACGUINEAS. So just to jump in on that, I think there are two sort of economic effects you want to be aware of. One is when your debt level is harming your economic growth, and the second is when it is triggering capital markets losing faith in you. So by all accounts, the best studies that are out there—and there is a new one just presented at Jackson Hole this summer—we are already in the danger zone where our total debt is already a drag on economic growth, which is one of the reasons that a debt consolidation plan would actually be pro-growth. Sometimes it has an immediate negative effect in the very short term, but in the medium and the long term, that would help us increase growth.

In terms of what level we need to be to avoid a fiscal crisis or capital markets losing faith in us, exactly what Doug said, nobody knows. It is really a psychological exercise. We—and Doug was on this as well—ran a commission, the Peterson-Pew Commission on Budget Reform, for the past 2 years, and the recommendation we came out with is stabilize the debt at 60 percent of GDP, at the time we said 2018. That now looks out of the range of possibilities, unfortunately. None of the plans in place would accomplish that. But we could credibly get to 65 percent of GDP by the end of the decade, and I think what you want to do is push yourself as far as you can get without taking a goal that is so high—I mean, we cannot get back to historical averages this year, this decade. We cannot balance the budget this decade in all likelihood. We would like to, but we are too far away.

So it seems to me that the range of 65 percent of GDP by the end of the decade is the right thing to be shooting for and that markets as well have kind of glommed onto that number and focused on that.

Senator HAGAN. Thank you, Mr. Chairman.

Chairman TESTER. Senator Wicker.

Senator WICKER. Well, Mr. Chairman, I want to thank you for putting together a balanced panel, and I think both the testimony today and the questions have been very helpful. So thank you.

Dr. Holtz-Eakin, let me begin with you. What is your understanding of the President's proposal with regard to tax increases on wealthier Americans? He has famously been referring to Warren Buffett and talking about the fact that Mr. Buffett's secretary pays a higher percentage in taxes than Mr. Buffett does. What is your understanding of exactly what the President is proposing and what effect that would have on the economy?

Mr. HOLTZ-EAKIN. I do not know exactly what he is proposing. It sounds——

Senator WICKER. You have been watching him pretty closely, haven't you?

Mr. HOLTZ-EAKIN. I do pay some attention, sir. I do not know the specific proposal. It sounds like something we already have, which is the alternative minimum tax, to make sure that those with high incomes pay a minimal rate. In that case, we should fix the alternative minimum tax instead of adding another layer of tax.

It also to my mind sounds like Mr. Buffett, although a famously successful financier, is not a very good tax policy analyst. The layers of taxes on many of those pieces of income start at the corporate level, and they are not reflected in that calculation.

And the last point I would make about this is all of the discussion today has focused on in particular Bowles-Simpson, but in general the need for tax reform being the route to higher revenues. Proposals that raise marginal tax rates go the wrong direction from a tax reform proposal. And what we need are a broader base, lower rates, better growth policy in our Tax Code, and none of these proposals are consistent with them.

Senator WICKER. Ms. MacGuineas, do you agree with that final statement about proposals that raise marginal rates being harmful to job creation and economic growth?

Ms. MACGUINEAS. I do. I do not think we are at a point where the marginal rates are so high that they are incredibly negative on the economy, but I think if we tried to solve this problem by raising marginal rates, that would be the complete wrong approach because we have a tremendous opportunity to reform the Tax Code in a way that actually lowers marginal rates. That is what happens when you have over $1 trillion a year in tax expenditures that probably misallocate capital more often than not and greatly complicate the Tax Code. So we have a remarkable opportunity to raise any revenues that we want to raise as part of a fiscal package while simultaneously lowering rates.

The thing that I do understand is I remember back in graduate school studying these tensions, and one of the biggest tensions is between economic growth and equity. And I understand the frustration that growing income inequality is at profoundly disturbing levels right now, and you want to think about ways, while we are dealing with fiscal problems, to try to get at that. But even if you want to make the Tax Code more progressive than it currently is, you can do that as part of fundamental tax reform while lowering rates overall as well. You can do distributional changes that are pro-growth as part of tax reform, and I would say that, if we want to change any of the distributional effect, should be how we do it. Increasing marginal rates just politically it is not the right way to start right now, but more importantly, economically it would be much less beneficial than the Bowles-Simpson type of approach to reforms.

Senator WICKER. Mr. Altman, do you want to respond to that?

Mr. ALTMAN. In effect, I want to add a footnote. I agree entirely with the points Maya just made, that the Bowles-Simpson approach—focusing on tax expenditures, broadening the base, lowering rates—is the best approach, and hopefully we will undertake serious broad-based tax reform soon. But just for the record, if the Bush high-earner tax cuts were to expire and we were to return to the Clinton rates, 39.6 on the top marginal rate, 20 percent on the capital gains rate and so forth, I think we have a lot of evidence during the 1990s that that was not damaging to economic growth, damaging to investment, damaging to financial markets. And I do not believe it would be again damaging.

Is it the optimal way to go? No. But would it have dreadful, terrible, catastrophic effects? I believe the answer to that is no.

Senator WICKER. OK. Back to you, Dr. Holtz-Eakin. Would you challenge that last statement of Mr. Altman?

Mr. HOLTZ-EAKIN. I am sure Roger is doing better empirical work than many who defend what went on in the late 1990s, but my concern is that you often hear this, "Well, we raised taxes and the economy grew like mad and everything was great." People forget we also had a tech bubble which, when it burst, provided the same level of losses as did the housing bubble bursting and caused a recession. That very same tech bubble was the source of the revenue surge that ultimately led to budget balance and surplus in the United States, and it was also fueled by the peace dividend with the decline of the Soviet Union.

I do not think anyone wants to go back to a world that relies on being safer in the globe—we are not—and having a bubble fuel both the Federal budget and private economic growth.

So I think the tax policy did not make that happen. I think other factors made it happen, and to raise taxes back to those levels in this environment would be a bad idea.

Senator WICKER. OK. Dr. Holtz-Eakin, let me begin with you on a second thread. This Congress passed and President Obama signed a stimulus package of approximately $820 billion early in 2009, and let me make my question bipartisan. In early 2008, there was a modest $152 billion stimulus bill passed by this Democratic Congress and signed by President Bush.

Did those two economic stimulus packages work? Were any part of them a success? Were they helpful in any respect?

Mr. HOLTZ-EAKIN. I would give——

Senator WICKER. And let me just do this because I do not want to interrupt you. If you had $821 billion to spend in early 2009, how could we have better spent it?

Mr. HOLTZ-EAKIN. So I am not a big fan of the 2008 episode. I think the evidence is pretty clear that that temporary stimulus, and many others designed that way, are largely ineffectual, and that one—there is nothing in the data to suggest it worked.

The 2009 I think you have to evaluate by a different standard. There is no President or Congress who would not have acted in those circumstances. You had to. And my reading of what we did with that is, you know, we threw nearly a $1 trillion at the economy. That has to have an impact. Assertions that there was zero impact from the stimulus just cannot be right. The work we have done suggests that—since we will never know what would have happened in the absence of it, it is always guess work. But the work we have done suggests that stopped the fall by about $1 trillion, and that was good. But there were not these grand multiplier effects that you hear so much about, that basically for every dollar we spent, we got $1 of GDP, maybe a little more. And that I think reflects the design flaws in that bill. The bill had numerous deficiencies. We have heard a lot about the shovel-ready things that really were going to take a long time. That was predictable. It also contained many things which were not about short-term stimulus but which were downpayments on a domestic policy agenda by the Administration. They should have actually focused on things which were genuinely short-term stimulus. And it was unrealistic, I think, to scale up some things and expect them to work. The best example is we used to have two $20 million rural broadband programs in the Federal budget, one in USDA and one in the Department of Commerce. That bill had $4 billion for rural broadband. There is not any organization in the public or private sector that can scale itself that much overnight and use the money effectively. It just cannot. And it was destined to fail. Worse, once attention got focused on things like that, everyone running such programs was afraid they were going to end up on "60 Minutes" as the poster child for waste, and so they started writing grant agreements that were ironclad so that they would be safe, and the money never went out.

And so it really was a flawed effort, and we could have done much better with the $800 billion.

Senator WICKER. Mr. Chairman, it is only you and I left on the panel. I have a number of other questions. Perhaps you would like to take another round or just tell me how you would like to proceed, but I have at least another round.

Chairman TESTER. No, no. We will do another round. I have just a couple left, and that would be good.

You folks have all described the fragility of this economy. I am going to start with you, Mr. Altman, given your background and your work. If the Super Committee was to come out with $3 to $5 trillion in reductions, how do you think the capital markets would respond? And just as importantly, how quickly would they respond?

Mr. ALTMAN. Overnight, and at least on the equity side and globally, very positively. It would be a big surprise. If we were getting to the verge of that, presumably we would all see that we were getting to the verge of it. But, in general, it would be a big surprise. It would be a huge positive surprise, and it would have a tonic-like effect. All markets would respond very positively. As I said a minute ago, interest rates in most sectors of the credit markets are already so low that I do not think they could go lower because they are so low for some of the wrong reasons. But the overall effect would be big and it would be overnight and it would be positive.

Chairman TESTER. And the potential for those interest rates to blow up would be minimized, do you think?

Mr. ALTMAN. Yes, although I do not think we are going to see any blowup soon, because as I say in my testimony, right now, as is the case so often with financial markets which have, by definition, a rather short term point of view, the focus is on the European sovereign debt crisis and the risks of recession in both Europe and the United States. That focus will return to our deficit and debt problem. It is just a matter of when. There is no doubt that it will return. And if we have not done much to solve it, that will be a bad time. But right now that is not what is preoccupying markets because the other two issues are so front burner. But I do not think there is a risk of blowup over the very short term. But as I said earlier, a failure on the part of the Super Committee, cannot agree, defaults to the sequester, is going to be taken quite poorly.

Chairman TESTER. Maya, as far as capital markets, do you agree?

Ms. MACGUINEAS. I agree completely. I think the question is what will happen if they come out with something in the medium size and whether that will be reassuring or not. But I think we know that there would be an immensely positive upside if they came out and exceeded expectations; and if they gridlock and they cannot get anything done, this is just going to be another sort of failure that keeps markets low and uncertainty high and is very damaging.

Chairman TESTER. Well, let me touch on that again, and we will get to you, Doctor, and you can address any of them you want. But if they come out with a medium size, what do you think is going to happen to the capital markets?

Mr. ALTMAN. Maya said earlier it depends on the composition of it, and it depends on the precise size. But so that I am not wishy-washy, I think if there is a successful outcome in the sense that the Super Committee actually reaches agreement and the package is bigger than the minimum, the reaction is going to be positive, not negative.

Chairman TESTER. Yes, go ahead, Maya.

Ms. MACGUINEAS. Just one quick point, which is I do think that if they were to come out with the minimum, the 1.2, but set in place the next stage so that we can sort of encompass all of go big in some stages but it is all one comprehensive piece, that would be reassuring. We cannot just say 1.2 and we are done, we will until after the election, because that is not going to do the trick. But if we keep this momentum building, I think that can be positive.

Chairman TESTER. I agree. Doctor.

Mr. HOLTZ-EAKIN. Just on the mechanics of it, I think a numerical success big enough to move the next debt ceiling increase past the election would be a very big win for the financial markets. And then in terms of looking at the markets to monitor the reaction, I just want to say what I think Roger said, which is look at the equity markets. I think that is going to be the key. We actually want interest rates to go up. We do not want them to spike and reflect a crisis, but higher interest rates, you know, throw me in that briar patch. That would mean we are actually growing. That would mean we are actually are looking more normal as an economy.

Chairman TESTER. OK. Taking it down to a small Main Street business, working-family perspective, how would they be impacted, either by the capital markets or by some sort of big agreement overall? What would be the positive impacts? What would be the negative impacts? Whoever wants to start can.

Mr. ALTMAN. Oh, maybe I will start. There should be a positive impact on credit availability. Right now a lot of lenders see this weakening economic condition, which leads, of course, to weaker credits for everybody, and lenders are very, very hesitant. We see that everywhere. So I think it would have a positive impact on the ability of a small business to borrow, at least at the margin.

I also think it should improve confidence levels at the business level and the consumer level. You should see—and this will not happen in a tidal wave sense, but you should see some improvements in consumer spending, and you should see some improvements in business investment and hiring. I do not want to imply they will be dramatic overnight, but some of those spigots should begin to turn a bit.

So I think there are benefits and that they will be meaningful over the medium term.

Chairman TESTER. OK. Maya or Dr. Holtz-Eakin?

Ms. MACGUINEAS. I think certainly there would be more stability than there currently is, and I think that would have the deepest effect on the business environment where some of the uncertainty is really causing businesses—you know, they have two problems right now. There is not sufficient demand, and there is certainly not enough stability and security for them to invest as we need to.

I think if we were to see a political compromise, we should not underestimate the huge increase in confidence that you would see in this country to see a functioning political system because people, as you all know from going back home, are so frustrated with—you know, the solution is in sight, and yet we cannot find the political way to get ourselves there.

Chairman TESTER. That is right.

Ms. MACGUINEAS. And I think the real advantage—and it is similar to your question about stimulus, but in some ways it is the counterfactual. What would happen if we do not do it? And the real advantage would be some things that families may never understand, which is how much better making some of these tough choices now, whether it is raising the retirement age gradually in the future or scaling back on some benefits or slightly higher taxes at some point, is so much better than waiting until markets force us to make these changes, where all of those tough choices will be there—we will have to do them all, and we will have to do them in a much greater scale, and we will not be able to protect people from dangerous tax hikes that would choke off the economy. And we will not be able to protect people from making more changes to the safety net than we otherwise would have to.

So it is doing it now in a thoughtful and gradual way that allows us all to protect the most important interests as opposed to waiting until we are hit with a crisis, which would be the worst across the board.

Chairman TESTER. OK. Dr. Holtz-Eakin.

Mr. HOLTZ-EAKIN. I think three things.

First, a crisis averted. It might not be visible, but it is the biggest benefit, and emphasis should be placed on that.

Second is I believe there will be beneficial business climate improvements, and that will mean jobs and growth. And that is the number one priority. It is going to be especially important among young people who have been disproportionately hurt by this recession, both in terms of the numbers and duration of their unemployment, the wage losses, and I think with people dropping out of the labor force, we are running the real risk of a cohort having marginal attachment to the labor force, and that leads to bad social problems. Main Street is not going to like that, so that would be a benefit.

The last thing is just that the mechanics of a household level, there is no real confidence in Social Security. Medicare has to be a scary proposition. There is an incentive then to save against a future that is really quite uncertain in their mind. Settling some of that would mean that they can concentrate on fixing household balance sheets, which is important, but not more. And they would then live better in the moment than they would otherwise, and that I think they would see right away.

Chairman TESTER. Good. Senator Wicker.

Senator WICKER. Thank you.

Ms. MacGuineas, could you briefly describe the additional health care reforms that you would have added to the Bowles-Simpson report? And would they have attacked the real problem with health care costs, namely, that they are rising at 3 to 4 times the inflation rate?

Ms. MACGUINEAS. Right. So as I mentioned before, I think probably the part that needs to be strengthened the most in Bowles-Simpson is to do more on health care. And a stark reality on all this is none of us know how to fix health care. This will be—you know, we can fix Social Security. We can do it. With health care we are going to have to go back a number of times. And so the answer, when it comes to health care, is we have to do everything we can possibly do, and I look at that as kind of three categories. One, there are the things that will save money, and they are not structural, but they will save some money. So if that comes from providers or wherever we can find that, that is a savings. It does not bend the curve.

The most important area——

Senator WICKER. We have hit the providers pretty hard.

Ms. MACGUINEAS. We have hit the providers very hard, and there is only so much—if there is even anything that you can squeeze out of there.

Senator WICKER. OK.

Ms. MACGUINEAS. That is short term, how you save money. What is really important is how you slow the growth. I think what came out of the Obama and Boehner discussions was critically important. Let us talk about raising the retirement age because that is one thing that we now have the ability to do in Medicare that would save money in ways that created better incentives. I think reforming the tax expenditures for the health care exclusion, which is part of Bowles-Simpson, but looking at that as aggressively as possible, would make a big difference.

I think greater levels of cost sharing is very, very important, and I think we have to look at that as aggressively as we can while protecting people who cannot afford to pay more. And I think malpractice——

Senator WICKER. You would do that at the higher-income level?

Ms. MACGUINEAS. I would do that at the higher end, and where you had to, at the medium levels. I mean, we have to—we cannot perpetuate this notion that health care is something that somebody else pays for for you. So bringing people closer to the effects and the prices helps us make better choices, just like it does in other markets, even though health care is not a normal market.

Then when it comes to the deepest structural reforms, I believe health care does need to have a budget that limits its growth.

Senator WICKER. I interrupted you, and you were about to say——

Ms. MACGUINEAS. I was about to say with medical malpractice and tort reform, I think that should be a piece of it. And depending on how you do it, it can save more or less money. But I think that is something we should look at. Basically every idea that is out there—I look at what Coburn and Lieberman did, I look at what all other outside groups have recommended, and I would do as much as we possibly can.

And then on structural reforms, I do think thinking about a version of premium support, which is the one that Domenici and Rivlin recommended, where you look at premium support, but it grows at more manageable, I think, levels than the proposal that has come out of the House on that, so the growth rate would be a little bit higher, and it stays in place—it keeps in place traditional Medicare as a parallel program, and you control costs of both of those, is a way to get at some of these deeper structural reforms we need to make. But we cannot have health care be open-ended indefinitely. We are going to need to put real budgets on that. There are different approaches to that. IPAB is another way to help control costs, and those all need to be considered to stay within a health care budget.

Senator WICKER. Let me begin with Mr. Altman, and then the other two can respond. Of the target of $1.2 trillion, realistically how much of that can be achieved through reductions in discretionary spending in the 10-year window?

Mr. ALTMAN. I think all of it can be achieved through discretionary spending, if it has to be. But if I interpret your question a little more broadly, that does not send a very encouraging signal because you are dealing with such a small portion of the total budget, and you are saying we cannot deal with entitlements, we cannot deal with revenues, and so we are going to do it entirely this way.

Would $1.2 trillion divided equally between defense and nondefense over 10 years be undoable? No, it would not be undoable, although I am sure there is a big, huge debate in the national security community as to whether that magnitude of defense cuts could be managed or not. My very amateurish judgment—but I do talk to a few people that know something, unlike me, about that—is that it could be. But it is not the ideal approach.

Senator WICKER. Dr. Holtz-Eakin, in answering the question, if you could discuss how severely we would have to get into those three core functions that you mentioned in your presentation of infrastructure, basic research, and national defense.

Mr. HOLTZ-EAKIN. I do not want to say none, but that would be my best advice, that, in fact, going with exclusively discretionary cuts comes with two very serious handicaps. One is that discretionary spending is where we locate those core functions—national defense, basic infrastructure, research—and those are things that we need to both do and do better in the United States. And I think it would be a mistake to focus the cuts there.

The second is that you cannot cut discretionary spending 10 years from now. Discretionary spending is done annually, and it is utterly unconvincing, given the budgetary history of the United States, to promise to cut discretionary spending 10 years from now. So I think markets are going to look at that and say, "Yeah, right."

Real changes to mandatory spending programs start now and stick and are far more compelling and the place that I think the Committee should be focused.

Senator WICKER. OK. Let me ask all three of you, and I will begin with you, Dr. Holtz-Eakin, and then we will just go down the panel, and this will probably end it up, Mr. Chairman, and I thank you for your indulgence.

If we go big and long, is it not true that we can have a very positive effect even if we do not reach much over the $1.5 to $2 trillion amount because we have done long-term structural things? And I am asking specifically about the really tough political things where the Chairman and I and the President would all have to agree to hold hands and jump off the high dive together. If we follow the suggestion of gradually raising the Medicare age for people who are under the age of 55 presently to eventually match the—bring the Social Security and Medicare ages together, if we redo the CPI to make it more accurately reflect the real world for retirees, if we do the means testing beginning at the top end for some of these entitlement benefits, if we do those sorts of things, we do not get as much punch in the 10-year window that we are talking about. But is it not a fact that we have really done better by future generations than doing some of the low-hanging fruit that Ms. MacGuineas talked about in her testimony?

Mr. HOLTZ-EAKIN. I completely agree. If the gentlemen you mentioned could hold hands and address Social Security, Medicare, Medicaid, and the Affordable Care Act, make fundamental changes to their trajectory over the long term, and hit only $1.2 trillion in the first decade, I think that would be an enormously beneficial step, and I think everyone would recognize it as such.

Senator WICKER. Mr. Altman.

Mr. ALTMAN. Well, of course, you cannot jump off the Washington Monument now because it is closed, but I agree with Doug. If the Super Committee, A, did more than the minimum and, B, took on the issue as you are talking about, the reaction and some of the benefits I said to Senator Tester in response to his question really would be very considerable, very positive result.

Senator WICKER. Ms. MacGuineas.

Ms. MACGUINEAS. Absolutely. It is a really important question—because if we could focus on something that would say raise the retirement age gradually, means-tested entitlements in the way that protected people who depend on them but asked for people who do less to give more, and I would also add into that at least some reform of tax expenditures—because do not forget, some of the tax expenditures are growing as quickly. They are just like entitlements, and some of the problematic ones. Boy, would that be a tremendous package. And the CPI as well, of course, which is a technical fix. There is absolutely no reason we should not be correcting a CPI which overstates inflation.

But all of those things have the benefit of having the savings compound over time so they would not show as huge savings in that 10-year window, but the effect they have is so important because what it does is it brings that debt level down.

Now, I do think that you want to have some savings in the 10 years because our debt levels need to be brought lower, but more important than that is that they are on that downward trajectory.

The only thing I would recommend is that just as Doug said about caps, things can be undone, you want to make sure that all those changes are credible and that there is a real political commitment to stick to them so that they are reassuring enough that those savings which would material more in the long run would come along as promised. And I think there are budget process maneuvers that could help tie up a deal like that. And anything along the lines of what you just put out would be immensely reassuring and helpful to the economy.

Senator WICKER. Well, thank you. I want to thank the panelists.

Let me just observe in closing, Mr. Chairman, almost every Senator who came and attended today spoke out in favor of going big and going long, and I would add what Senator Hagan said, going smart. I immediately embraced the concept of the Group of Six. It was an idea that was so trashed at once from both the right and the left that it was dead on arrival by sundown of that very day.

I think there is a willingness on this panel and in this Senate and both ends of the Capitol to do something tough at this moment of divided Government. I serve in a Democratically controlled Senate. The House of Representatives is Republican. The executive branch is Democratic. And, frankly, the agencies and the regulatory bodies are largely Democratic. But this is an ideal time—it is actually the perfect time to do big things where we all have our fingerprints on them, and we cannot make them an election issue afterwards.

I would just suggest to my Democratic friends and to anyone within the sound of my voice that if the President of the United States would step forward and give a clear signal to the Super Committee that he is willing to be engaged in this, he is willing to endorse this, he is willing to say early on that he would sign legislation that goes big and goes long, I think we could get it done *a la* Tip O'Neill and Ronald Reagan, and we would actually have something that we can tell our grandchildren that we did for their future.

Chairman TESTER. Thank you, Senator Wicker, and I do not think there is a soul, on this panel at least, that does not agree this is the preeminent issue we have got to deal with. So we are going to have to get on the same page.

Instead of talking about the good things that can happen with the good, long-term big package, I want to talk about the other side of the equation. Let us say that the Super Committee cannot come to any sort of real recommendations. Let us say that the sequestration is evident that it is going to start and with that will be bills brought up to the Senate, at least, and probably the House to eliminate programs that will be sequestered, for example—well, one of them, military spending has already been brought up. We are not going to do that.

Give me some sort of idea—and I think I know what your answer is going to be, but give me some sort of answer on what that would do, that not only do we not come to some sort of $1.2 trillion discussion, or much bigger than that, but also the sequestration that has been mandated by the agreement that was done on the debt ceiling, there are inroads into that so that that does not even happen. Give me some sort of idea. Doug, you can start.

Mr. HOLTZ-EAKIN. Well, I think, you know, obviously you would have severe disappointment in markets. I am firmly convinced that you would see more agencies downgrade U.S. credit ratings. I think you would see markets steadily reevaluating the relative position of the U.S. versus other places to park their money. Because it is always relative, we can, you know, be the best-looking horse in the glue factory or the world's tallest pygmy or a lot of things that we are right now, but markets at some point are going to decide someone else is just a little bit better, and that would trigger the more dramatic reaction.

You do not want to find out when that happens. We do not need that experiment, and we should avoid it.

Chairman TESTER. Thanks. Roger.

Mr. ALTMAN. Well, Senator, I agree with what Doug said. Let me just add one element. Right now there is a widespread expectation that the Super Committee is going to fail to agree, and that expectation, among other things, is being underscored by Members of Congress themselves who often privately rather than publicly are themselves saying that.

So the expectations are awfully low right now, and apart from agreeing with everything Doug said, one of the advantages of actually achieving an agreement, especially if it were above the minimum, it would be such a surprise. You know, it would be doubly beneficial because it would be confounding the conventional wisdom.

Chairman TESTER. Maya.

Ms. MACGUINEAS. It is terribly discouraging because I think the trigger is a real problem. Peterson-Pew came out with a number of recommendations about how to build a trigger, and basically there are two ways you want to do it. You want to create a trigger that either is something that if it went into place would be a good thing. Like a good trigger would be, well, if you do not come up with an option, Bowles-Simpson goes into place. Right? You pick a default that is good or that is strong enough that it causes people to act but they will not bypass it.

This trigger, so much of it is security. You can already see people lining up to be concerned about it. So many things are exempt. We recommended that you have broad-based triggered both on revenues and on spending so both parties would hate them and you not exempt any program so that all people would say we do not want this to hit.

So I am concerned that the design of the trigger is not as effective, and the main thing that is going to cause action is not just the threat of the sequester, but that it is the right thing to do, that there is this huge outcry to do the right thing. And you can just see from the comments we have heard today on this, the Senators who have been here have just asked all the right questions and showed the momentum to do the right thing. That is what is going to push it more than the sequester, I believe.

Chairman TESTER. I would agree. I want to thank you all very much for your testimony. As I said when I met you earlier today, I appreciate the work you have done in preparation for this Committee, and I appreciate your insights about this whole process and how it can work very, very well or how it might turn into a train wreck.

I can tell you from a personal standpoint, one of the reasons I wanted to have this hearing, as Senator Bennet said, this is a very important issue. But we also need to give the Super Committee the knowledge to know that there are a lot of people out there that want to see this thing work and work well for our country and for our kids. And now is the time to act. We cannot continue, we just cannot continue to kick the can down the road.

I remain optimistic. My fellow Senator from Montana, Max Baucus, is on that Committee. I hope that he as well as the other five Senators can provide solid leadership to bring forth comprehensive deficit reduction. I think it is the Senate's—I think it would serve the Senate well, and I think there are—I mean, as I counted it up here, I think almost everyone one of us, if not every one of us, are part of the Gang of 35, if that is a gang or group or whatever you want to call them, pretty much evenly split, Democrats and Republicans, that want to see a big reduction plan.

As was pointed out, as we look to the future, this is 3 percent. My God, we ought to be able to do that with our hands tied behind our back.

So just as a formality, this record will remain open for 7 days for any additional comments and questions that might be submitted for the record. I once again want to thank you all. You may come from different political persuasions, but I think I heard a hell of a lot more agreement than I did disagreement today. I very much appreciate that because I agree with what you said.

Thank you all. We are adjourned.

[Whereupon, at 11:46 a.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF MAYA MACGUINEAS

PRESIDENT, CENTER FOR A RESPONSIBLE FEDERAL BUDGET

OCTOBER 5, 2011

Chairman Tester, Senator Vitter, Members of the Subcommittee, thank you for inviting me here today to discuss the economic problems presented by our budget deficit.

I am Maya MacGuineas, president of the bipartisan Committee for a Responsible Federal Budget and the director of the Fiscal Policy Program at the New America Foundation. I am also a member of the Peterson-Pew Commission on Budget Reform, which recently released two reports—Red Ink Rising and Getting Back in the Black, which focus on the need to adopt multiyear debt targets and automatic triggers to help improve the budget process.

Our debt as a share of the economy is now higher than it has ever been in the postwar period, and we are on track to continue adding to it indefinitely. In all likelihood, the debt is already a drag on economic growth, and without changes, it will at some point result in a fiscal crisis.

At the same time, we face serious economic challenges: a slowing economic recovery, unemployment at unacceptably high rates, and a number of persistent problems from a skills shortage, underinvestment in a number of critical areas, and an abysmal, inefficient, and anticompetitive tax code, all of which stand in the way of longer-term growth. So we have our work cut out for us.

The debt owed to the public grew from $9.0 trillion, or 62 percent of GDP, at the end of fiscal year 2010 to $10.1 trillion, or 67 percent of GDP, at the end of fiscal year 2011. Under the Congressional Budget Office's current law baseline, debt is projected to grow to $14.5 trillion by 2021. Interest payments alone would be over $660 billion in 2021.

Yet, these assumptions are likely wildly optimistic. The Committee for a Responsible Federal Budget recently updated its "Realistic Baseline", which includes more realistic assumptions about future tax and spending policies than the current law assumptions CBO is directed to follow.* Our baseline shows deficits at nearly $1.1 trillion, or 4.5 percent of GDP, by the end of the 10-year window; public debt growing to $19.4 trillion, or 81 percent of GDP; and interest payments reaching $815 billion in 2021.

Fig. 1: CRFB Realistic Baseline

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Ten Year
Billions of Dollars											
Net Interest	$238	$265	$297	$351	$437	$535	$618	$688	$754	$815	$4,998
Deficits	$978	$829	$663	$636	$747	$753	$791	$902	$992	$1,071	$8,362
Debt	$11,158	$12,097	$12,870	$13,616	$14,461	$15,313	$16,198	$17,188	$18,264	$19,416	N/A
Percent of GDP											
Net Interest	1.5%	1.6%	1.8%	1.9%	2.3%	2.7%	3.0%	3.1%	3.3%	3.4%	2.6%
Deficits	6.2%	5.1%	3.9%	3.5%	3.9%	3.8%	3.8%	4.1%	4.3%	4.5%	4.3%
Debt	71.2%	74.8%	75.8%	75.1%	75.7%	76.5%	77.3%	78.5%	79.9%	81.5%	N/A
Memorandum: CBO Baseline*											
Net Interest	1.5%	1.6%	1.7%	1.9%	2.1%	2.4%	2.6%	2.7%	2.8%	2.8%	2.3%
Deficits	6.2%	3.2%	1.6%	1.1%	1.5%	1.2%	1.0%	1.2%	1.2%	1.2%	1.8%
Debt	71.2%	72.8%	71.6%	68.7%	67.2%	65.8%	64.3%	63.1%	62.0%	61.0%	N/A

*CBO baseline figures refer to current law projections assuming $1.2 trillion in savings related to the Joint Select Committee are put in place.

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* The CRFB Realistic Baseline assumes the 2001/2003/2010 tax cuts are fully extended, the AMT continues to be patched, war costs slowly decline, and scheduled reductions to Medicare payments to physicians continue to be waived for remainder of the decade. It does not assume the $1.2 trillion in savings the Joint Select Committee on Deficit Reduction has been charged with.

Under realistic assumptions, debt will continue to grow over the coming 10 years, and then continue to rise to over 100 percent of the economy in the late 2020s, to over 200 percent in the 2050s, and eventually to nearly 400 percent by 2080. Obviously, we would experience a fiscal crisis well before it would ever get to these points.

Large deficits and debt have a number of negative effects.

- They harm the economy by diverting capital from productive investments to finance Government borrowing, which will inevitably push up interest rates and the cost of capital for families and businesses. A number of academic studies find that high debt levels are already likely negatively impacting the U.S economy. [1]
- From a budgetary perspective, high debt levels lead to higher interest payments which squeeze out other Government spending and lead to higher taxes. Higher interest burdens also leave the Government more vulnerable to increases in interest rates. The Congressional Budget Office recently found that if interest rates were one percentage higher each year than currently projected, it would lead to $1.3 trillion in additional interest costs over the next decade. [2]
- High debt levels lead to loss of fiscal flexibility. Though the past recession was quite severe, we escaped a far worse outcome due to our ability to borrow to smooth out some of the economic shocks. With our current higher debt levels, we no longer have as much fiscal space to respond to emergencies, and doing so will be much more difficult and costly in the future if the debt trend is not reversed.
- From an intergenerational perspective, excessively high deficits and debt reflect the basic policy of our spending, yet refusing to pay for it, and passing the bills along to future generations, along with a lower standard of living than they would otherwise enjoy. This inequity is exacerbated by the fact that the bulk of our Government spending goes to consumption—much of it for the elderly—rather than investments, which would at least have the potential to boost longer-term growth.
- The uncertainty that comes from businesses and households knowing the changes will have to be made, but not knowing what they are, makes planning and investing significantly more difficult than if policy changes were already clearly put in place. The lack of certainty is one of the major factors causing businesses to keep their cash on their balance sheets rather than making productive investments that would help create jobs and grow the economy.
- Finally, ultimately, unsustainable levels of debt will lead to some type of a fiscal crisis. Once unimaginable in the United States, we should no longer see ourselves as immune from such a crisis.

The solution to all of the risks of higher debt is a multiyear, comprehensive fiscal plan that would stabilize the debt at a manageable level and set it on a course to decline as a share of GDP. The sooner we enact such a plan, the better.

We should aim to bring the debt down to around 60 or 65 percent of GDP over a decade—still significantly higher than the historic average of below 40 percent, but more manageable—and continue to bring it down to precrisis levels over the following decade. All areas of the budget should be on the table.

The debt threat is extremely serious, but it is also an opportunity to restructure our budget and tax system for the 21st century. By shifting our budget from one directed towards consumption to investment, we can lay a new foundation for growth. In order to be competitive down the road, we must strengthen critical investments in human capital, infrastructure, and high value research and development. And our tax system needs to be fundamentally reformed to both help grow the economy and raise more revenues to help close the fiscal gap.

Debt Reduction as an Engine for Economic Growth

It is important to recognize that debt reduction is not at odds with economic growth strategy, but rather, a central part of one. Putting in place a credible multiyear debt stabilization plan immediately has a number of economic advantages.

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[1] *See,* Stephen G. Cecchetti's September 2011 paper: "The Real Effects of Debt". *http://www.kc.frb.org/publicat/sympos/2011/2011.Cecchetti.paper.pdf*, and Carmen Reinhart and Kenneth Rogoff, "Growth in a Time of Debt". *http://www.ycsg.yale.edu/center/forms/growth-debt.pdf*

[2] *See,* the Congressional Budget Office's January 2011 "Budget and Economic Outlook". *http://www.cbo.gov/ftpdocs/120xx/doc12039/01-26__FY2011Outlook.pdf*

First, a credible debt reduction package reduces the negative consequences of excessively high debt levels, including pressure on interest rates and payments. The Congressional Budget Office has analyzed the potential impacts of a multitrillion debt reduction plan over the course of a decade and has found that while it can dampen economic growth in the short-term, the overall size of the economy later in the decade and over the long-term can be notably larger. CBO estimates that by 2021, real GNP could increase by 0.6 to 1.4 percentage points from a $2.4 trillion debt reduction plan, compared to what otherwise would have occurred,[3] The International Monetary Fund has also found that fiscal consolidation in high-debt countries will be beneficial and likely increase output over the long-run.[4] There is also evidence that the announcement itself of a credible, long-term debt reduction can have positive economic effects in the short-term effects by improving confidence and pushing down long-term interest rates. Finally, debt reduction would reduce or eliminate the risk of a fiscal crisis.

Second, a credible, multiyear debt reduction plan can help free up enough fiscal space upfront to allow the economic recovery to continue to take hold. Rather than implementing immediate spending cuts and tax hikes, budgetary changes could be phased in more gradually, putting the debt on a glide path to stable and then declining levels. Gradual changes would also allow beneficiaries of our entitlement programs and taxpayers more time to adjust. But, a plan does need to be credible to be effective. Three keys to a credible plan are:

- It must be put in statute, not just promised.
- It must be bipartisan so that there isn't an immediate push by either political party to undo it.
- It must include a well-designed fiscal rule to ensure that savings are realized as promised and that the plan stays on track. Such rules could include spending caps at the levels of an agreed-upon plan, and broad-based automatic triggers that provide savings if policies fall short. The more difficult to override, the better. The Peterson-Pew Commission reports and the Gang of Six plan include a number of budget process reforms that should be integrated into any debt reduction plan to help ensure that stays on track.

Third, a multiyear plan will provide businesses and households more confidence and stability, allowing them to spend, invest and plan in ways that will help the economy.

Fourth, the added pressures on spending will likely lead to better oversight of Government programs and reforms or elimination of outdated, ineffective, and redundant spending programs. This is also an important opportunity to transition the U.S. budget from a consumption-oriented budget to an investment-oriented one, which will be critical to long-term economic growth. In so doing, consumption oriented programs would be cut, while spending on many key areas of productive public investments would be increased. Our current incremental approach to deficit reduction is doing just the opposite of thoughtfully reassessing our priorities and their effects on economic growth, and we are instead chipping away at the absolute wrong parts of the budget.

Finally, a comprehensive plan to stabilize the debt, if large enough, will by necessity include reforms to entitlement and the tax system, which if done prudently, will help grow the economy. Examples of such pro-growth structural reforms would include:

- Fundamental tax reform like what the Bowles-Simpson Fiscal Commission proposed, which dramatically reduces tax expenditures, lowers rates—including corporate tax rates, and uses a share of the revenues for deficit reduction.
- Entitlement reform—particularly health and pensions, not only because this is primarily where our fiscal challenges lie, but because fundamental reforms would allow us to more efficiently use our country's resources, and provide better incentives for consumptions, savings, and work.

While smaller budget deals are less likely to include fundamental overhauls of major entitlement programs and the tax code, a larger deal would encompass all

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[3] *See*, the Congressional Budget Office's July 16, 2010, report: "The Macroeconomic and Budgetary Effects of an Illustrative Policy for Reducing the Federal Budget Deficit". *http://www.cbo.gov/ftpdocs/123xx/doc12310/07-14-DeficitReduction_forweb.pdf*

[4] *See,* the October 2010 International Monetary Fund, World Economic Outlook, "Chapter 3: Will It Hurt? Macroeconomic Effects of Fiscal Consolidation". *http://www.imf.org/external/pubs/ft/weo/2010/02/pdf/c3.pdf*

areas the budget and could reform them in a way to create better growth incentives and reduce the deficit simultaneously.

Our tax code is simply a massive mess. It is littered with over 250 special credits, deductions, exemptions, and exclusions that cost us nearly $1.1 trillion a year. These "tax expenditures" are truly just spending by another name. By reducing, if not eliminating, many of them, we can reduce tax rates to more effectively encourage work and investment, while also helping to reduce deficits. Fundamental tax reform is critical in turning our fiscal situation around and strengthening our economic well-being.

To be large enough in the medium and long-term, and to reassure markets that a plan is serious, entitlement reform and tax reform must be at the center of any fiscal turnaround plan.

While the policy choices involved in tackling our out of control debt are not easy, they are far easier than what we will face if we continue to delay. One thing should be clear: it is preferable to make these difficult budget choices on our own terms then if and when they are forced upon us by credit markets.

As it stands now, the new Joint Select Committee, or Super Committee, is tasked with recommending savings of $1.5 trillion over 10 years. This, however, is unlikely to be sufficient to stabilize the debt. Instead, we would urge the Super Committee to "Go Big" by implementing a larger plan that would be sufficient to stabilize the debt at a manageable level and, in so doing, to tackle the most problematic areas of the budget, including health and retirement entitlements and taxes. Specifically, we urge the Super Committee to:

1. *Go Big.* From a realistic baseline in which current policies are extended, $1.5 trillion is not nearly enough to stabilize the debt. The Super Committee should look at all areas of the budget in order to achieve more savings, with a goal of stabilizing the debt as a share of the economy and then putting it on a downward path.
2. *Go Long.* Any serious fiscal plan must address the long-term drivers of our growing debt. The Super Committee should enact serious reforms to Social Security—which seems to be all but forgotten in this discussion—as well as Medicare, Medicaid, and other Federal health spending.
3. *Go Smart.* Without economic growth, it will be difficult if not impossible to get our fiscal situation under control. The Super Committee should pursue pro-growth tax reform which broadens the base and lowers rates, and should reprioritize spending to better encourage short- and long-term growth.
4. *Stay Honest.* The Super Committee must not rely on budget gimmicks to make it appear that they identified savings to meet their target or that the problem was solved, while failing to fix the problem in reality.
5. *Make It Stick.* Once savings have been identified, the Super Committee should put in place an enforcement regime to ensure savings materialize as promised.

Thank you to the Committee for all your work on this and the opportunity to appear here today, and I look forward to your questions.

APPENDIX 1

Appendix 1: Overlapping Policies and Estimated Savings Across Fiscal Plans

Deficit-Reducing Policies	President's Super Committee Submission	House Republican Budget	Bowles-Simpson Fiscal Commission	Domenici-Rivlin (BPC)*	Under Consideration in Debt Limit Discussions+	Lieberman-Coburn Health Proposal
Government-Wide						
Use Chained CPI for All Inflation-Indexed Programs**			**$232 billion** from implementing chained CPI	**$232 billion** from implementing chained CPI	Under discussion by Obama and Boehner	
Health Care						
Reform Medicaid Formula	**$15 billion** from introducing a reduced blended Medicaid rate in 2017	**$770 billion** from block granting Medicaid and indexing to CPI + population	Recommends consideration of block granting to meet long-term health cap	Replaces matching rates with reallocation of federal/state responsibilities beginning in 2018	**$100 billion** from unspecified FMAP changes (with possible increased state flexibility)	
Reduce State Medicaid Gaming	**$26 billion** from reducing Medicaid provider tax threshold		**$51 billion** from phasing out Medicaid provider tax threshold		Under discussion as part of Medicaid reform	
Improve Dual Eligible Care			**$15 billion** from mandating dual eligibles be placed in Medicaid managed care (with Medicare capitated payments)	**$8 billion** from removing barriers for states to place dual eligibles in managed care	**$0-$5 billion** from better care coordination	
Enact Tort Reform		**$62 billion** from aggressive reforms, including caps to non-economic and punitive damages	**$20 billion** from reforms such as collateral source rule changes and consideration of aggressive reforms	**$62 billion** from requiring states to cap non-economic and punitive damages		

Deficit-Reducing Policies	President's Super Committee Submission	House Republican Budget	Bowles-Simpson Fiscal Commission	Domenici-Rivlin (BPC)*	Under Consideration in Debt Limit Discussions⁺	Lieberman-Coburn Health Proposal
Reduce Medicare Payments for Pharmaceutical Drugs	**$142 billion** from prohibiting pay for delay for generic drugs ($3b), shortening exclusivity for generics ($4b), and drug rebates ($135b)		**$55 billion** by applying Medicaid drug rebates to low income seniors covered by Medicaid and Medicare Part D	About **$160 billion** by expanding Medicaid drug rebates to Medicare Part D	Part D rebates proposed by Dems; other reforms, such as average wholesale price (AWP) rules for Part D drugs and drug reclassifications also considered	
Increase Medicare Cost-Sharing	More than **$1 billion** from increasing the Part B deductible and introducing a home health co-payment for new beneficiaries in 2017		**$65 to $75 billion** from a $550 deductible, 20% co-insurance up to $5,500, 5% co-insurance up to $7,500, and catastrophic cap above that	About **$30 billion** from a $560 deductible, 20% co-insurance up to $5,250 and catastrophic cap above that	Up to **$66 billion** from clinical lab and skilled nursing facilities (SNF) / Home Health co-pays (though money could also come from payment reduction)	**$65 to $75 billion** from a $550 deductible, 20% co-insurance up to $5,500, 5% co-insurance up to $7,500, and catastrophic cap above that
Increase Basic Medicare Premium				About **$240 billion** from raising basic Part B premiums from 25% to 35% of costs (5-year phase-in)		About **$240 billion** from raising basic Part B premiums from 25% to 35% of costs (5-year phase-in)
Increase Medicare Means-Testing	**$20 billion** from increasing means-testing premiums and freezing brackets beginning in 2017				**$38 billion** from freezing premium brackets after 2019 and increasing costs for high-earners	Increases catastrophic cap for high-earners and requires high-earners to pay 100% of premiums

Deficit-Reducing Policies	President's Super Committee Submission	House Republican Budget	Bowles-Simpson Fiscal Commission	Domenici-Rivlin (BPC)*	Under Consideration in Debt Limit Discussions*	Lieberman-Coburn Health Proposal
Restrict Medigap Coverage	Over **$2 billion** from a Medicare Part B surcharge on beneficiaries who purchase Medigap policies with low cost sharing requirements for new beneficiaries beginning in 2017		**$53 billion** from restricting first-dollar coverage of Medigap plans		Up to **$53 billion** from restricting first-dollar coverage of Medigap plans	**$53 billion** from restricting first-dollar coverage of Medigap plans
Enact Medicare Premium Support		Implements premium support for new retirees in 2022, with $8,000 yearly subsidy indexed to inflation	Pilots premium-support in FEHB and recommends consideration of premium support after 2020	Implements premium support in 2018 for current and new retirees, allowing traditional Medicare to compete, indexed to GDP+1%		
Reduce Post-Acute Care Payments	**$42 billion** from reducing payment updates for post-acute care providers and other reforms		**$9 billion** from accelerating home health cuts under PPACA		Up to **$50 billion** from cutting home health and SNF payments (though savings could come from cost-sharing)	**$9 billion** from accelerating home health cuts under PPACA
Raise Medicare Eligibility Age			Recommends consideration of eligibility age increase to meet long-term targets		Raising age from 65 to 67 under discussion by Obama and Boehner	**$124 billion** from raising the eligibility age to 67 between 2014 and 2025

Deficit-Reducing Policies	President's Super Committee Submission	House Republican Budget	Bowles-Simpson Fiscal Commission	Domenici-Rivlin (BPC)*	Under Consideration in Debt Limit Discussions*	Lieberman-Coburn Health Proposal
Reform TRICARE and/or TRICARE for LIFE	**$22 billion** from a TRICARE for Life premium and higher TRICARE drug co-pays		**$43 billion** from applying Medigap restrictions on first dollar coverage to TRICARE for Life		Up to **$17 billion** from increasing drug co-pays under TRICARE	
Reform Federal Employees Health Benefits (FEHB) Program	**$2 billion** from reforming FEHB pharmacy benefit contracting		**$22 billion** from converting FEHB into premium support with fixed contribution amounts and having FEHBP subsidize Medicare premium instead of first dollar coverage		Up to **$11 billion** from allowing FEHB benefit to subsidize Medicare premium instead of first dollar coverage	
Reduce Medicare Bad Debt Payments	**$20** billion from reducing bad debts payment		About **$25 billion** from phasing out payments for bad debts		**$14-$26 billion** from phasing out payments for bad debts	**$25 billion** from phasing out payments for bad debts
Changes in Special Hospital Payment Policies	**$15 billion** from reducing Graduate Medical Education payments and payments to rural hospitals		**$70 billion** from reducing subsidies to hospitals for direct and indirect graduate medical education costs		**$28 billion**, half from graduate (direct and indirect) medical payments and half from rural hospitals	
Reduce Spending from the Affordable Care Act	**$18 billion** from correcting income definition rules for insurance subsidies and reducing spending on the Prevention and Public Health Fund	About **$590 billion** from repealing the coverage and tax provisions of the Affordable Care Act	Calls for reforming or repealing the CLASS Act, which could *cost* up to $87 billion in the first decade but reduce the deficit in future decades		**$10 billion** from not allowing the Prevention and Public Health Fund to grow and repealing Frontier State Adjustments	

Deficit-Reducing Policies	President's Super Committee Submission	House Republican Budget	Bowles-Simpson Fiscal Commission	Domenici-Rivlin (BPC)*	Under Consideration in Debt Limit Discussions+	Lieberman-Coburn Health Proposal
Reform the Sustainable Growth Rate (SGR)	Assumes a permanent freeze to reimbursement rates		**$36 billion** (compared to a 10-year freeze) from a -1% update in 2014 and directing CMS to develop an improved payment formula that encourages care coordination and quality over quantity			Provides 3-year SGR fix to give time for lawmakers to develop new Medicare reimbursement mechanism for physicians

Deficit-Reducing Policies	President's Super Committee Submission	House Republican Budget	Bowles-Simpson Fiscal Commission	Domenici-Rivlin (BPC)	Under Consideration in Debt Limit Discussions
Other Mandatory Spending					
Reduce Farm Subsidies	**$33 billion in net savings** from eliminating direct payments, reducing subsidies for crop insurance, and better targeting of conservation assistance programs, with a portion of the savings used to extend mandatory disaster assistance	**$28 billion** from reductions in direct payments and crop insurance	**$12 billion in net savings** from $18 billion in savings from reductions in direct payments and other subsidies as well as reduction in conservation and market assistance programs), with $6 billion in new spending to extend disaster fund	**$34 billion** from cutting payments to commercial farms, reforming crop insurance, and cutting conservation program spending	**$33 billion** from $31 billion in farm subsidy cuts and $2 billion in cuts to conservation programs
Reform Pension Benefit and Guaranty Corporation (PBGC)	**$16 billion** from increasing PBGC premiums and allowing PBGC to set its own premium rates	**$3 billion** from increasing PBGC premiums	**$10 billion** from allowing PBGC to set its own premium rates	**$5 billion** from increasing PBGC premiums	**$9 billion** from unspecified changes
Auction Spectrum Licenses	**$18 billion** of *net* savings mainly from incentive auctions, with some spending on broadband funding	**$25 billion** mainly from incentive auctions	Less than **$5 billion** from continuing existing auction authority; recommends Congress consider incentive auctions		**$20-$25 billion** in net savings from incentive auctions with a portion of auction proceeds redirected to new spending

Deficit-Reducing Policies	President's Super Committee Submission	House Republican Budget	Bowles-Simpson Fiscal Commission	Domenici-Rivlin (BPC)	Under Consideration in Debt Limit Discussions
Reform Federal Civilian and Military Pension Benefits	Establishes a BRAC-like process to review military retirement benefits, but does not set a savings target or assume any savings	**$1 billion** from eliminating special retirement supplement	Establishes a task force to evaluate federal health and retirement benefits, but makes illustrative suggestions of up to **$27 billion** for pension savings from increasing computation years from 3 to 5 and eliminating COLAs before age 62 with a 1-time catch up	**$9 billion** from using highest 5 years of earnings to calculate civilian benefits and reforming military retirement into one based on FERS	**$47 billion** ($36 billion from civilian and $11 billion from military) including from increasing contributions and benefits changes. Also, chained CPI for COLAs under consideration by Obama and Boehner
Increase Pension Contributions for Federal Employees	**$21 billion** from increasing employee pension contributions from 0.8% to 2%	**$122 billion** from equalizing employer and employee contributions to civilian pensions	Up to **$66 billion** from gradually equalizing employer and employee contributions to civilian pensions#		
Eliminate In-School Interest Subsidies on Student Loans	^	**$46 billion** from eliminating subsidies for undergraduate and graduate students^			Up to **$46 billion**, with the possibility of some of the money going to strengthen Pell Grants
Fannie and Freddie Reform	**$28 billion** from guarantee fees	**$30 billion** from unspecified reforms			**$30-$32 billion** from increasing guarantee fees and other reforms
Aviation Security / FAA Fees	**$26 billion** from increasing aviation security fees and introducing new fees on non-commercial aircraft			**$21 billion** from moving to $5 flat fee per one-way flight for aviation security	Up to **$18 billion** from moving to $5 flat fee for aviation security, and a per flight plan FAA fee

Deficit-Reducing Policies	President's Super Committee Submission	House Republican Budget	Bowles-Simpson Fiscal Commission	Domenici-Rivlin (BPC)	Under Consideration in Debt Limit Discussions
U.S. Postal Service Reforms	**$19 billion** from health benefit reforms, refunding the surplus given to FERS program, giving Postal Service authority to move to five-day delivery, allowing non-postal items to be sold, and allow products to be priced in accordance with costs		Calls for removal of restrictions that prevent Postal Service from taking action to reduce losses, such as five-day delivery and closing down of some offices		**$11-$26 billion** from allowing Postal Service to adjust postal rates, among other changes
Improve Tax Enforcement	Up to **$30 billion** from "cap adjustments" for tax enforcement		Up to **$30 billion** from "cap adjustments" for tax enforcement		
Reduce Food Stamps		**$127 billion** from block granting food stamps at "pre-recession projected levels" in 2015			Republicans proposed **$20 billion** in savings from categorical eligibility, "heat & eat", and job training
Sell Excess Federal Real Property	**$4 billion** from disposing of excess real property		Directs GSA to loosen agency restrictions on selling unused buildings and land		
Reform National Flood Insurance	**$4 billion** from phasing out premium subsidies for certain properties			**About $10 billion** from adjusting insurance subsidies for risk	

Deficit-Reducing Policies	President's Super Committee Submission	House Republican Budget	Bowles-Simpson Fiscal Commission	Domenici-Rivlin (BPC)	Under Consideration in Debt Limit Discussions
			Tax Reform		
Reform Employer Health Exclusion	**$410 billion** in additional revenue by limiting itemized deductions for high earners, and then calls for tax expenditure reform. Also implements the "Buffett Rule" in which people with income over $1 million cannot face a lower effective tax rate than people earning less than $1 million	Calls for revenue neutral comprehensive tax reform, which could include elimination of various preferences	Calls for comprehensive reform. Illustrative plan phases out exclusion between 2014 and 2038	Phases out exclusion between 2018 and 2028	
Reform Mortgage Interest Deduction			Calls for comprehensive reform. Illustrative plan replaces deduction with 12% credit up to $500,000, only for primary residences	Replaces deduction with 15% credit up to $500,000 for primary residences only	Elimination of deduction on second homes under discussion by Biden group
Reform Charitable Deduction			Calls for comprehensive reform. Illustrative plan replaces deduction with 12% credit and 2% of AGI floor	Replaces deduction with 15% refundable credit given directly to charitable organization	Democrats proposed limiting itemized deduction for high-earners
Reform State and Local Deduction			Calls for comprehensive reform. Illustrative plan eliminates deduction	Eliminates deduction	
Reform Tax Treatment of Retirement Accounts			Calls for comprehensive reform. Illustrative plan consolidates accounts, caps contributions, and expands savers' credit	Caps contributions and expands saver's credit	

Deficit-Reducing Policies	President's Super Committee Submission	House Republican Budget	Bowles-Simpson Fiscal Commission	Domenici-Rivlin (BPC)	Under Consideration in Debt Limit Discussions
Corporate Tax Reform	**$62 billion** from eliminating various business tax expenditures. Then, calls for corporate tax reform that broadens base and lowers rate	Calls for comprehensive tax reform which targets a rate of 25%	Calls for comprehensive reform. Illustrative plan eliminates corporate all tax expenditures, lowers rate to 28%, and moves to a territorial system	Eliminates most corporate tax expenditures and reduces rate to 27%	White House offered corporate tax reform, including corporate jets and LIFO rules, but offer was rejected
Eliminate Fossil Fuel Tax Preferences	**$4 billion** in budget from reducing various preferences, and calls for tax expenditure reform in framework	Comprehensive tax reform which could include elimination of various preferences	Comprehensive tax reform which could include elimination of various preferences	Eliminates all tax expenditures related to oil and gas	Elimination of domestic manufacturing credit for big five integrated oil companies under discussion

Deficit-Reducing Policies	President's Super Committee Submission	House Republican Budget	Fiscal Commission	Domenici-Rivlin (BPC)	Under Consideration in Debt Limit Discussions
Social Security					
Raise Social Security Retirement Age	Calls for improved WEP/GPO compliance with states and localities, but does not address or mention Social Security reform beyond that. However, the April Budget Framework called for Social Security reform, parallel to deficit reduction, which would strengthen security for low-income earners and the most vulnerable and restore long-term solvency without privatization or reducing the "basic benefit" for current beneficiaries.	Establishes Social Security trigger requiring action by the Administration and Congress in any year in which the Social Security Trustees project the system to be insolvent over the next 75 years. The President would be required, in conjunction with the Social Security Trustees, to put forward a plan to restore solvency, and Congress would be required to consider those recommendations or alternative proposals under an expedited process.	**Closes 18% of 75-year shortfall** from indexing the retirement age to life expectancy, with hardship exemption	**Closes 22% of 75-year shortfall** from indexing benefit formula to account for increases in life expectancy	
Reduce Benefit Formula for Higher Earners			**Closes 29% of 75-year shortfall** from creating bendpoint at median income and reducing PIA factors to 90%|30%|10%| 5%	**Closes 4% of 75-year shortfall** from reducing top PIA factor from 15% to 10%	
Increase Social Security Taxable Maximum			**Closes 35% of 75-year shortfall** from gradually raising the payroll tax cap to cover 90% of wages	**Closes 35% of 75-year shortfall** from gradually raising the payroll tax cap to cover 90% of wages	
Add State and Local Government Workers to Social Security			**Closes 8% of 75-year shortfall** from adding newly hired state and local workers beginning in 2021	**Closes 8% of 75-year shortfall** from adding newly hired state and local workers beginning in 2020	
Apply Chained CPI to Social Security*			**Closes 26% of 75-year shortfall** from using chained CPI to calculate annual COLAs	**Closes 26% of 75-year shortfall** from using chained CPI to calculate annual COLAs	Under consideration by Obama and Boehner

This list is not exhaustive of overlapping policies.

*Estimates for BPC proposals extrapolated out to 2021 and estimated without interaction from premium support or Medicaid overhaul by CRFB staff.

**Switching to the chained CPI would increase revenues by $72 billion, reduce Social Security outlays by $112 billion, and reduce other spending by $48 billion over ten years. To read more, see CRFB's Moment of Truth project policy paper at http://crfb.org/document/measuring-case-chained-cpi.

+ Policies under discussion during debt ceiling debate as defined by memo from Congressman Eric Cantor, unless otherwise noted.

^$18 billion in additional recommended savings already enacted as part of Budget Control Act.

APPENDIX 2

THE COMMITTEE FOR A
RESPONSIBLE FEDERAL BUDGET

What We Hope to See from the Super Committee

SEPTEMBER 7, 2011

NOTE: This paper has been updated from the version that was originally published.

THE COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET

ABOUT

The Committee for a Responsible Federal Budget

The Committee for a Responsible Federal Budget is a bipartisan, non-profit organization committed to educating the public about issues that have significant fiscal policy impact. The Committee is made up of some of the nation's leading budget experts including many of the past Chairmen and Directors of the Budget Committees, the Congressional Budget Office, the Office of Management and Budget, the Government Accountability Office, and the Federal Reserve Board.

New America Foundation

Since 2003, the Committee for a Responsible Federal Budget has been housed at the New America Foundation. New America is an independent, non-partisan, non-profit public policy institute that brings exceptionally promising new voices and new ideas to the fore of our nation's public discourse. Relying on a venture capital approach, the Foundation invests in outstanding individuals and policy ideas that transcend the conventional political spectrum. New America sponsors a wide range of research, published writing, conferences and events on the most important issues of our time.

What We Hope to See from the Super Committee

Introduction

Tomorrow, the Joint Select Committee on Deficit Reduction ("Super Committee") will hold its first meeting as part of a three-month effort to identify $1.5 trillion in deficit reduction over the next decade. Should the Super Committee fail to reach a majority agreement on a plan, or should that plan (or else a balanced budget amendment) not be passed by Congress, a $1.2 trillion across-the-board spending cut will go into effect.

Unfortunately, even if Congress succeeded in adopting a $1.5 trillion deficit reduction plan, it might not be enough to put the budget on a sustainable path. Thus, we urge the Super Committee to:

Go Big. From a realistic baseline in which current policies are extended, $1.5 trillion is not nearly enough to stabilize the debt. The Super Committee should look at all areas of the budget in order to identify savings of two to three times as much, with a goal of stabilizing the debt as a share of the economy and then putting it on a downward path.

Go Long. Any serious fiscal plan must address the long-term drivers of our growing debt. The Super Committee must enact serious reforms to Social Security, Medicare, Medicaid, and other federal health spending.

Go Smart. Without economic growth, it will be difficult if not impossible to get our fiscal situation under control. The Super Committee should pursue pro-growth tax reform which broadens the base and lowers rates, and should reprioritize spending to better encourage short- and long-term growth.

Stay Honest. The Super Committee must not rely on budget gimmicks to make it appear that they identified savings to meet their target or that the problem was solved, while failing to fix the problem in reality.

Make It Stick. Once savings have been identified, the Super Committee should put in place an enforcement regime to ensure savings materialize as promised.

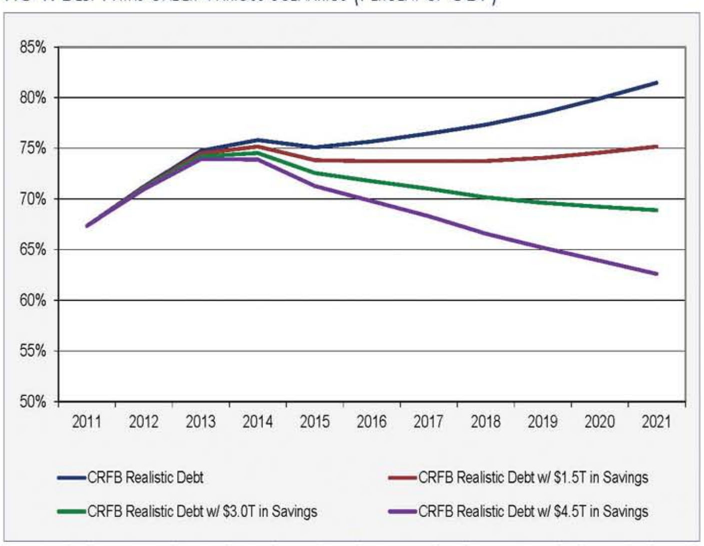
Go Big

The new Super Committee is charged to identify $1.5 trillion in deficit reduction, though $1.2 trillion would be enough to avoid an automatic sequester. While this would represent significant savings, Committee members should be shooting to double or triple this target in order to put the debt on a sustainable course.

Relative to CRFB's Realistic Baseline (see Box 1 for explanation), $1.5 trillion in savings would keep our debt on an upward path – growing from 67 percent of GDP this year to over 75 percent by 2021. By comparison, the Fiscal Commission recommendations would bring the debt down to 65 percent by 2021; the Peterson-Pew Commission on Budget Reform has recommended reducing debt to 60 percent.

Indeed, relative to CRFB's Realistic Baseline, it would take $3 trillion in deficit reduction just to reduce the debt to below 70 percent of GDP by 2021 and put it on a modestly downward path. Identifying an amount of deficit reduction significant enough to put the debt on a downward path will likely require looking at all areas of the budget, including the major entitlements, other mandatory programs, and the discretionary budgets; it will also require looking at ways to generate additional revenues. The Appendix to this paper identifies many policy changes where consensus may be possible.

FIG 1. DEBT PATHS UNDER VARIOUS SCENARIOS (PERCENT OF GDP)



Note: For details on CRFB Realistic Baseline, see http://crfb.org/document/analysis-cbos-august-2011-baseline-and-update-crfb-realistic-baseline. Committee savings assumes $1.5 trillion in debt reduction gradually implemented over ten years.

BOX 1. WHAT'S IN A BASELINE?

The Budget Control Act that created the Joint Committee on Deficit Reduction (Super Committee) called for the Congressional Budget Office (CBO) to score its recommendations relative to current law, but allows the Super Committee to present alternative estimates. This means the Super Committee could choose an alternative baseline, which can heavily influence the total and/or relative amount of savings from any one plan.

Relative to current law, which assumes all the 2001/2003/2010 tax cuts expire, the AMT is not patched in the future, and policymakers stop enacting "Doc Fixes," $1.5 trillion would be sufficient to bring the debt down to 60 percent of GDP.

In measuring the magnitude of the problem and whether the Committee has solved it, however, assuming that these policies which have been extended in the past all expire does not provide an accurate picture of the future.

CRFB's Realistic Baseline assumes policymakers continue these policies as they have in the past, and also assumes the wars in Iraq and Afghanistan drawdown as expected. Compared to this baseline, $1.5 trillion would only result in debt levels of 75 percent of GDP as opposed to 81 percent absent those changes. Under a similar baseline – but one in which the upper-income tax cuts were allowed to expire as President Obama has called for – $1.5 trillion would bring the debt to 71 percent of GDP.

FIG 2. DEBT HELD BY THE PUBLIC IN 2021 UNDER VARIOUS SCENARIOS (PERCENT OF GDP)

Super Committee Savings	Current Law Baseline	CRFB Realistic Baseline Assuming Upper-Income Tax Cuts Expire	CRFB Realistic Baseline (All Tax Cuts Continued)
No Savings	66%	78%	81%
$1.5 trillion	60%	71%	75%
$3.0 trillion	53%	65%	69%
$4.5 trillion	47%	59%	63%

Note: Current policy baseline assumes all 2001/2003/2010 income and estate tax cuts are extended, AMT patches and yearly "doc fixes" continue, and wars are drawn down.

Go Long

No responsible deficit reduction plan can ignore the long-term growth of entitlement spending. It may be possible for the Super Committee to achieve its required savings without serious reforms to Social Security, Medicare, and Medicaid; however, with such a package the Super Committee would fail to meet its mandate to (emphasis added) "significantly improve the short-term and ***long-term*** fiscal imbalance of the federal government."[1]

1 Text from Title IV of Budget Control Act of 2011, P.L. 112-25.

Base on our projections, federal health and retirement spending is slated to grow substantially from below 10 percent of GDP today to 12 percent by 2021, 15 percent by 2035, and 17 percent by 2050. This is due both to population aging (largely because of the retirement of the baby boom population) and to rapid health care cost growth.

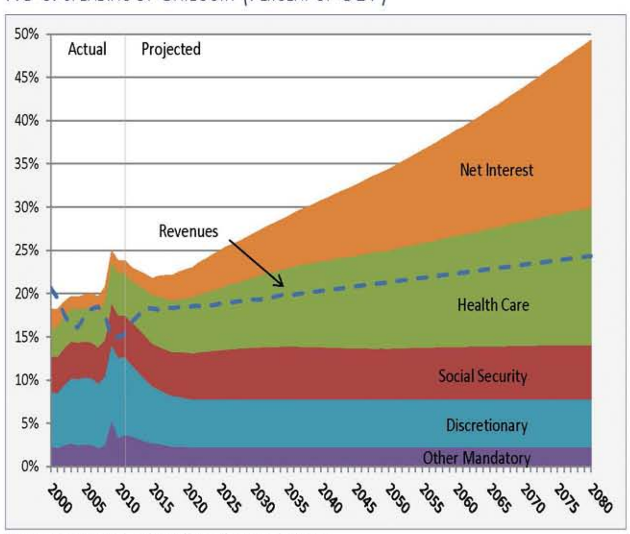
To reassure markets and put our budget on a sustainable path over the long-term, the Super Committee must therefore address the growth of the nation's largest entitlement programs, and give priority to those reforms with the potential to slow long-term growth paths (even if they do not have significant scoreable savings this decade). Reforms to Social Security, Medicare, and Medicaid are central to improving the long-term imbalances.

For Social Security, fixes are well known and developed – and there is no legitimate excuse for continuing to defer action. As the program's own Trustees continue to warn, Social Security is on the path toward insolvency, with cash deficits growing from 0.3 percent of GDP today to 1.4 percent of GDP by 2035. By 2036, according to the latest estimates, the Social Security trust funds will be empty and all beneficiaries will be hit with a 23 percent benefit cut. This can be easily avoided by enacting gradual changes today which phase-in over the coming decades.

Health care spending is more complex, but as the single largest cause of our long-term deficits, it cannot be ignored.

The Super Committee should start by reviewing those proposals which we already know would help to control costs – including changing cost sharing rules, reducing provider payments, increasing premiums, adjusting the Medicare eligibility age, reforming Medicaid rules, enacting malpractice reform, and

FIG 3. SPENDING BY CATEGORY (PERCENT OF GDP)



Source: Congressional Budget Office and CRFB calculations.

expanding payment reforms under the health reform law, to name a few. The Super Committee must also seriously consider long-term structural reforms such as moving to a premium support system for Medicare, putting federal health spending on a budget, and/or reforming and strengthening the Independent Payment Advisory Board (IPAB) to better control costs.

The Appendix describes the overlap in recommendations made across multiple deficit reduction plans that could guide the Super Committee's decisions in these areas.

Go Smart

To be successful, a debt reduction plan should not simply pursue savings without consideration of the economic effects. Instead, it should make smart and sensible reforms to the budget and tax code with an eye on enhancing (or at least not impeding) economic growth.

While we will not be able to grow our way out of this problem, higher growth will make the difficult task of fixing the budget much more manageable. According to CBO, growing just 0.1 percent faster than projected each year would generate more than $300 billion in deficit reduction over a decade.

Over the medium and long-run, deficit reduction itself would be pro-growth by increasing the nation's investment capacity; but the composition of the deficit reduction policies will also be critically important.

Super Committee members should therefore recommend reducing lower-priority spending in order to create the fiscal space to maintain or even increase high-priority and pro-growth spending. Over the medium- to long-term, this means moving from a consumption-based budget to one which focuses more on investment.

On the revenue side, the key will be pro-growth tax reform. Fundamental reform, which broadens the base by reducing deductions, credits, exemptions, and other tax expenditures; simplifies the code; and lowers individual and corporate tax rates, has the potential to substantially improve economic growth while also generating additional revenue for deficit reduction. The Joint Committee on Taxation has estimated that income tax reform that wipes out most tax expenditures in order to lower marginal rates, could increase the size of the economy by 1.2 to 1.9 percent of GDP over the medium-term, and more over the long-term.[2]

With a meaningful and credible fiscal plan, deficit reduction can be phased in gradually to give the economy time to recover. Even the announcement of such a plan can have positive effects on business and consumer confidence, particular if the plan is sufficiently large to create certainty over the nation's long-term outlook.

Stay Honest

The formal mission of the Super Committee leaves much room for gimmickry. Though they are tasked with identifying $1.5 trillion in deficit reduction, their mandate does not identify a baseline. This means that the Committee could, for example, claim more than $1.3 trillion in savings from simply taking credit for the

2 Joint Committee on Taxation, "Macroeconomic Analysis Of A Proposal To Broaden The Individual Income Tax Base And Lower Individual Income Tax Rates," December 14, 2006. http://jct.gov/publications.html?func=startdown&id=1186

BOX 2. BASELINES AND CURRENT POLICY EXTENSIONS

If the Super Committee members judge their savings against the current law baseline, which assumes that policies set to expire do expire (including the 2001/2003/2010 tax cuts and AMT patches), ideally they should explicitly address expiring provisions. There are a number of ways lawmakers could responsibly address expiring provisions:

- Make specific policy recommendations that supersede expiring provisions, such as fundamental tax reform or Medicare payment formula reforms;
- Make specific policy recommendations about which policies to extend in the context of a sustainable debt path;
- Or, create a clear process for dealing with expiring provisions in the near future, with enforceable limits on the costs of extending those or alternative policies.

If the Super Committee does not address expiring provisions under current law in one of the above manners, the Committee members will inherently be implying that current policies will stay in place. Any projections of the Super Committee's recommendations would then have to be compared to realistic assumptions about likely extensions to policies in place today.

already-planned troop withdrawals in Iraq and Afghanistan.[3]

To be credible, the Super Committee must not inflate their savings or paint an overly optimistic picture of the resulting fiscal path. In fact, rather than focusing on the *amount* of deficit reduction, the Super Committee should put forth recommendations sufficient to put the debt on a stable then declining path under a reasonable set of assumptions. All assumptions in the baseline should be ones policymakers plan to stick to (so for instance, assuming the cuts in Medicare spending from the Sustainable Growth Rate occur and increased revenues from the Alternative Minimum Tax affecting millions more taxpayers should not be acceptable).

Committee members should also avoid other budget gimmicks, such as arbitrary and excessive back-loading of savings, timing gimmicks which push costs beyond the budget window, or unrealistic policy changes which future Congresses are likely to reverse.

Make It Stick

Even once policies are adopted, more will be needed to make sure they are not undone. History shows that having agreed upon deficit reduction measures is no guarantee that they will come to fruition.

Enacted savings could fall off course one of three ways: by lawmakers repealing deficit reducing measures, enacting future spending increases or tax cuts without offsets to give back some of the savings, or by changes in budget projections due to economic or other factors.

To help ensure savings materialize (or at least make it more difficult for lawmakers to undo the savings),

3 By convention, the baseline assumes that spending on Iraq and Afghanistan will continue to grow with inflation. Setting caps on this spending that reflect the already anticipated drawdown would therefore be scored as achieving $1.12 trillion below the baseline – along with another $200 billion in interest savings.

the Peterson-Pew Commission on Budget Reform recommended one approach in that lawmakers should reinforce their agreement by enacting budget rules and procedures to keep the debt on a stable or declining path.[4] Such a process would work both by helping to monitor and facilitate progress on achieving necessary savings, and by putting "triggers" in place to keep the debt on track if policymakers fail to do so.

Other approaches also exist to institute effective budget enforcement and outcomes. Lawmakers could choose to rely on annual savings relative to a particular baseline, aggregate spending targets (as some lawmakers have already proposed), revenue or deficit levels, or other fiscal metrics.

There are many ways to help make debt reduction policies stick, but stronger budget rules and oversight can never compensate for the political will that is needed to enact and adhere to savings in the first place.

***

The Super Committee is on a very tight deadline, but its success is imperative. All three major rating agencies have suggested there could be consequences should the Committee deadlock – and more importantly, there may not be many opportunities like the current one to truly bring our debt under control. Right now, all eyes are on this issue, policymakers are invested in this process, and there is a unique fast-track process in place. Waiting until next year will mean addressing the issue in the heat of a Presidential election, and waiting beyond that could not only make things politically more difficult, but could also be too late to reassure markets. The types of structural changes needed to put the budget on a sustainable path just become more and more difficult, both economically and politically, the longer policymakers delay action.

4 Peterson-Pew Commission on Budget Reform, *Getting Back in the Black*, November 2010.

ADDENDUM

Eye on the Market | October 5, 2011 J.P.Morgan

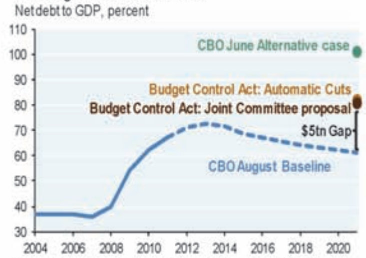
Topics: Why financial markets are paying close attention to the Joint Select Committee on Deficit Reduction

In August, the United States lost one of its AAA credit ratings, a designation first bestowed around 100 years ago. Since that time, financial markets have struggled to regain their footing, reflecting concern global investors have about the ability and willingness of both the US and Europe to tackle their respective fiscal challenges. With US federal debt approaching its highest level since the formation of the federal government in 1789 (other than during WWII and its immediate aftermath), rating agencies are taking a close look at rising US debt ratios and what the legislature does to contain them. The appetite of foreign central banks to accumulate Treasuries has provided the US with a reprieve; these entities, plus Federal Reserve holdings, now account for more than half of all Treasury bonds. But monetary policy in Asia and the Middle East is subject to change, and we have seen in Europe the suddenness with which sovereign debt can be re-priced by financial markets. From an investment perspective, the downgrade, government shutdown rumors and political impasse on deficit reduction are negatively affecting equity markets, business activity and consumer confidence. This note details 10 reasons why we believe financial markets will take a very close look at whether the Joint Select Committee on Deficit Reduction ("JSCDR") exceeds its $1.5 trillion deficit reduction target; simply reaches the target; undershoots the target, relying on sequestered cuts for the rest of the $1.2 trillion minimum; does not come to agreement and settles for sequestered spending cuts of $1.2 trillion; or worse still, introduces legislation to eliminate some of the sequestered cuts, as has been suggested in recent days.

[1] The Budget Control Act represents progress, but does not yet set federal debt on a sustainable path. As shown, the Budget Control Act reduced the trajectory of federal debt compared to the CBO's Alternative Case published in June 2011. However, even after incorporating the BCA, future debt ratios still rise into the low-80s as a percentage of US GDP. The CBO's August Baseline shows a *decline* in federal debt since it assumes three policy options that have not been implemented: sunset of all Bush tax cuts, an end to indexation of AMT to inflation, and reductions to Medicare doctor reimbursements which Congress has agreed to but never enacted. These three cuts and associated interest savings would amount to roughly $5 trillion in deficit reduction over a 10 year period. Congress might not pursue these options and chose a different set of deficit reduction measures and amounts; either way, it would take roughly $2 trillion on top of the $1.5 trillion in 10-year deficit reduction already assigned to the JSCDR to stabilize the federal debt. CEOs, corporate treasurers and entrepreneurs we talk to consistently mention a desire to see a declining trajectory of federal debt when discussing long-term capital spending and hiring plans.

U.S. long-term debt scenarios

Net debt to GDP, percent



Source: Congressional Budget Office, J.P. Morgan Private Bank.

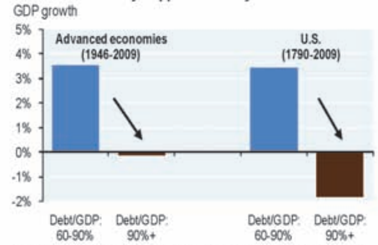
[2] Financial markets are focused on this issue since large deficits and debt levels can affect growth. There are plenty of debates in the economics community these days (e.g., why haven't monetary or fiscal stimulus multipliers behaved the way their supporters believed they would). One possible explanation is that fiscal stimulus loses its effectiveness when debt ratios rise too high. In the chart below, we summarize Ken Rogoff's findings that when debt ratios in the US and in other advanced economies have exceeded 90%, economic growth suffered notably. With the US federal debt ceiling now over 100% of GDP (on a gross debt basis) and projections of net debt rising above 80%, financial markets have reason to be concerned.

Supporting Rogoff's findings is a paper prepared by BIS economists for the Fed's 2011 Jackson Hole symposium[1]. In a study of sovereign, corporate and household debt over the last 3 decades, the authors find that at ~85% of GDP, government debt exerts a significant negative drag on growth. Their conclusion:

> *"the immediate implication is that countries with high debt must act quickly and decisively to address their fiscal problems. The longer-term lesson is that, to build the fiscal buffer required to address extraordinary events, governments should keep debt well below the estimated thresholds."*

What fiscal austerity supporters worry about: 90% cliff

GDP growth



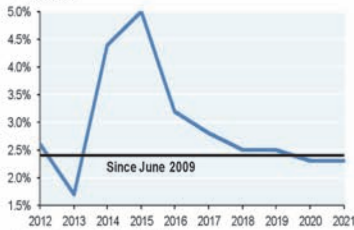
Source: "Growth in a Time of Debt", Carmen Reinhart and Kenneth Rogoff, January 7, 2010, National Bureau of Economic Research.

[1] *"The Real Effects of Debt", Cecchetti, Mohanty and Zampolli, BIS, presented at the Fed's August 2011 Jackson Hole symposium.*

Topics: Why financial markets are paying close attention to the Joint Select Committee on Deficit Reduction

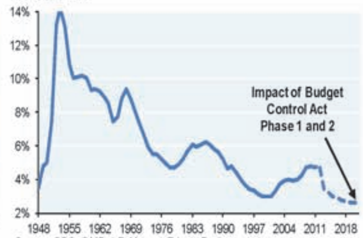
[3] If US growth does not pick up, debt ratios would rise further. The estimate of 83% net federal debt to GDP by 2021 includes CBO assumptions for growth shown in the chart below. CBO estimates include a spike to 5% in 2015, for reasons we have not seen explained. If US growth averaged 2.5% instead (resulting in lower GDP, lower government revenues and higher unemployment insurance), debt ratios could approach 90% by 2021. While we are hopeful that the US economy recovers more quickly, if the JSCDR doesn't reach $1.5 trillion in deficit reduction with the promise of more to come, there would be no room for error, and a chance of another round of downgrades. Despite S&P's computational error discovered during its downgrade and its poor track record rating housing-related securities, rating agency bashing by politicians is not a convincing rationale for investors to ignore the consequences of the rising federal debt. After adjusting for its error, S&P's downgrade logic still holds.

CBO's real GDP growth assumptions
Percent YoY



Source: Congressional Budget Office.

US military spending since 1940
Percent of GDP



Source: CBO, OMB, J.P. Morgan Private Bank.

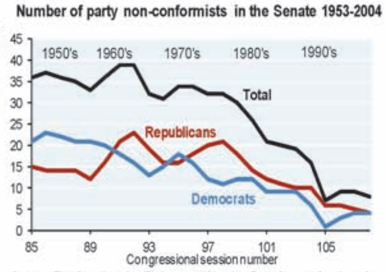
[4] Projections of military spending declines are unlikely to be seen as "real" deficit reduction. One item in the President's recent budget proposal was an assumed $1.1 trillion in savings from troop withdrawals out of Iraq and Afghanistan (so-called "OCO" spending). While this foregone spending *might* happen, it is not a legislated change, and is determined as much by geopolitics and uncontrollable circumstance as by the Congress. In addition, as shown in the chart above, the Budget Control Act *already* projects that non-OCO military spending as a % of GDP will fall to its lowest level since 1940, barely above the levels now spent by Japan and Germany after decades of demilitarization. As a result, financial markets are unlikely to ascribe a high likelihood to additional deficit reduction achieved primarily through lower *estimates* of future military spending.

[5] **It is not just S&P that is unnerved by the polarization of political parties**. Markets are aware of the polarization in the Congress, a trend that can be understood by empirical analysis of Congressional voting patterns. As shown below, the polarization in the House and the Senate is as high as it has even been, even higher than after Reconstruction, one of the most acrimonious periods in the country's history. A closer look at the Senate in particular (below, right) shows that the number of party non-conformists has plummeted. Without a political middle, there is a greater risk that the ideological divide between the parties cannot be bridged, leading to intermittent government shutdowns (or the threat of them[2]) and frequent market disruptions. While the difference between sequestered cuts and consensus cuts is only $300 billion over ten years, the ability of the JSCDR to achieve consensus will be painstakingly followed by market participants for these reasons.

Party polarization at an all time high, 1879-2010
Degree of partisanship as measured through analysis of all Congressional roll calls

Source: Keith T. Poole, University of California - San Diego, January 2011.

Number of party non-conformists in the Senate 1953-2004



Source: *The Creation of an Endangered Species: Party Nonconformists of the U.S. Senate*, Richard Fleisher and Jon R. Bond, 2005.

[2] Financial markets are aware that the latest compromise avoiding a government shutdown was mostly a reflection of FEMA discovering that it had underestimated the amount of funds that it had on hand. So there wasn't a compromise at all, since Congress didn't need to make one.

Topics: Why financial markets are paying close attention to the Joint Select Committee on Deficit Reduction

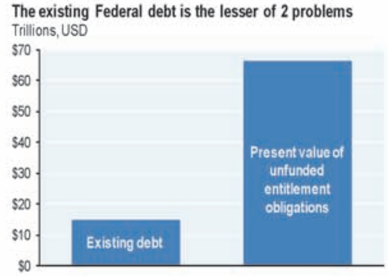
[6] Entitlements: where we are now. Market participants are increasingly focused on rising entitlements relative to other discretionary spending. First, some history. When Medicare was introduced in 1960's, it was described as "brazen socialism" in the Senate. When Truman proposed a national healthcare program in the 1940's, the plan was called a Communist plot by a House subcommittee. And when President Roosevelt introduced Social Security in the 1930's, he was branded as a Communist sympathizer by Republican Senators from Ohio, Pennsylvania and Minnesota, publisher William Randolph Hearst and Alf Landon (Roosevelt's GOP opponent in the 1936 Presidential election). So in 1969, when one quarter of Americans over the age of 65 lived in poverty, politicians showed courage in creating a larger social safety net. **However, it may take even greater courage to examine and adjust what they created.** In the late 1960's, the government estimated that Medicare expenses would grow by 7 times by 1990 (unadjusted for inflation); they grew by *61 times* instead. As shown in the table below, in section (a) healthcare spending has overtaken education spending; section (b) entitlements have grown sharply compared to growth in population, household income and overall government spending; section (c) price-sensitive medical spending (paid out-of-pocket) has collapsed; and section (d) more "productive" forms of government spending have fallen to an all-time low. David Walker, the former Comptroller of the US, refers to this as the "crowding out" of productive discretionary programs.

	Indicative entitlement trends: 1960-2010	1960	1970	1980	1990	2000	2009/10
(a)	Healthcare spending (% of GDP)	1%	3%	4%	5%	6%	8%
	Education spending (% of GDP)	4%	6%	5%	5%	6%	6%
(b)	Entitlement program enrollment (% of population)	N/A	18%	22%	25%	27%	29%
	Entitlement income (% of avg. pre-tax income)	N/A	8%	11%	11%	12%	15%
	Social Security spending (% of total federal spending)	N/A	15%	20%	20%	23%	20%
	Medicare spending (% of total federal spending)	N/A	3%	5%	8%	11%	13%
	Medicaid spending (% of total federal spending)	N/A	1%	2%	3%	7%	8%
(c)	Price sensitive out-of-pocket spending (% of healthcare spending)	48%	33%	23%	19%	14%	12%
	Medicare/Medicaid (% of healthcare spending)	N/A	18%	25%	26%	32%	35%
(d)	"Productive" federal spending (% of total federal spending)	N/A	68%	54%	46%	36%	32%
	Includes spending on defense, education, infrastructure and technology						

Source: Kleiner Perkins Caufield & Byers. 2009/10 reflects latest data point available.

[7] Entitlements: where we go from here. Financial markets generally look at financial statements which are governed by GAAP accounting, which requires accrual of future commitments. Countries and states are not bound by accrual accounting, leaving markets to wonder (and sometimes panic) when they find out what hasn't been accrued. The existing federal debt, which is already at elevated levels, does not include the present value of unfunded future entitlement payments. The authors of USA Inc have estimated this number at $66 trillion, which is 5 times the existing stock of federal debt (similar to other analyses from the National Center for Policy Analysis and the Federal Reserve Bank of Dallas). How much would tax rates have to rise to support entitlements growing at 5%-7% per year, with trend nominal GDP growth expectations of 4%-5%? First, the 2001 tax cuts would have to expire on all brackets, and then tax rates would have to be raised by the same amount on everyone. At that point, federal debt to GDP ratios would still be well above 2007 levels, but at least it would create some borrowing capacity to fund entitlement payments. The question is what such a policy would do to growth and employment.

The existing Federal debt is the lesser of 2 problems



Source: OMB, US Treasury, Center for Medicare & Medicaid Services, Kleiner Perkins Caufield & Byers.

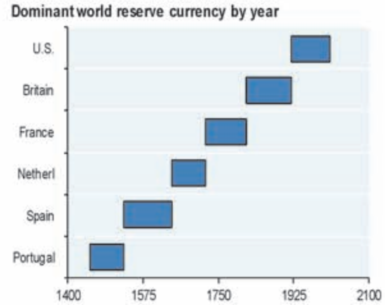
Topics: Why financial markets are paying close attention to the Joint Select Committee on Deficit Reduction

[8] **How long will China keep buying?** US Treasury markets have benefitted substantially from the appetite of Chinese and other central banks to accumulate Treasury bonds. As shown below, China's purchases of $1.5 trillion in Treasuries and Agencies is unprecedented, even when compared to other industrializing countries with managed exchange rates. While China has prospered by doing this (keeping its exchange rate cheap and exporting more), it is a policy that carries substantial risk, primarily in the form of higher Chinese inflation. As a result, it would be a mistake to expect this pace of reserve accumulation to last forever. Eventually, the US Treasury will once again have to rely on private markets to finance its deficits and stock of debt. Proactive work by the JSCDR will be needed to ensure that this transition is a viable one. Japan is illusory as an example of high federal debt and low interest rates: 93% of all Japanese government bonds are held by Japanese investors.

Chinese foreign exchange reserve accumulation

Source: IMF, BEA, The Cabinet Office, China National Bureau of Statistics, BBK, The Bank of Korea, J.P. Morgan Private Bank.

Dominant world reserve currency by year

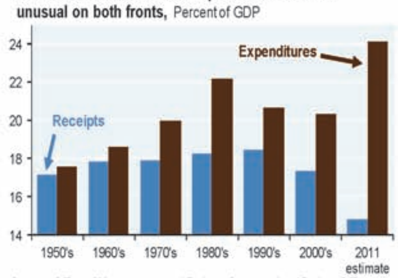


Source: Hong Kong Monetary Authority.

[9] **Risks to the status of the dollar as the world's reserve currency**. The primary reason that China accumulates Treasury bonds is that its central bank is looking for large, liquid, secure places to put trillions of their own currency. The most sensible place to find such an investment: the world's reserve currency. The percentage of global reserves held in dollars has not changed much recently (around 65%), nor has the percentage of global FX transactions denominated in dollars (85%). However, financial markets are well aware of the catalysts that led to the end of reserve currency status over the last few centuries. In general, they are: an over-extended fiscal budget, too much money-printing, declines in productivity, military over-extension and the inability to adjust to changing times, circumstances and adversaries. Financial markets understandably look at the actions of the Congress and the President on issues like these. The JSCDR's actions will be an important marker on the timeline of the United States and its ability to sustain its economic primacy of the last 100 years. For the record, as shown in the chart above, that's about as long as most reserve currencies last.

[10] **What economic model does the United States want to use?** One of the most frequently asked questions is this: why are price-earnings ratios so low? P/E multiples, adjusted for inflation, are at their lowest levels in decades. This reflects in part the concern that the United States hasn't figured out which model it wants to use; it mixes a European style welfare state with a libertarian tax regime. The JSCDR is being asked to figure out how to reconcile these two things, and until they do, financial markets are likely to remain in very uncertain territory, negatively impacting both consumer and business confidence.

Government revenues and expenditures: 2011 is unusual on both fronts, Percent of GDP



Source: Office of Management and Budget, Congressional Budget Office.

Real S&P 500 trailing earnings yield

Trailing earnings yield of the cap-weighted S&P 500 less core CPI

Source: Robert Shiller, S&P, corporate reports, Empirical Research Partners.

Topics: Why financial markets are paying close attention to the Joint Select Committee on Deficit Reduction

My son recently asked me what I thought was the most important document in US history. There are a lot to choose from, but of all the possibilities, I picked George Washington's Farewell Address, written in 1796. The relevance of Washington's warnings regarding the importance of unity, the threat of political factions, the importance of the separation of powers, the dangers of permanent foreign alliances and the need for public morality and education have not diminished with time. One entire section in Washington's Farewell Address is devoted to the use of public credit, and Washington is quite clear about what he thinks about passing the buck to future generations:

"***As a very important source of strength and security, cherish public credit. One method of preserving it is to use it as sparingly as possible…avoid accumulation of debt, not only by shunning occasions of expense, but by vigorous exertions in time of peace to discharge the debts which unavoidable wars have occasioned, not ungenerously throwing upon posterity the burden which we ourselves ought to bear.***"

Michael Cembalest
Chief Investment Officer
J.P. Morgan Asset Management

Additional sources to consult on the long-term deficit outlook

- A January 2011 paper from the *Committee for a Responsible Federal Budget*, a group made up of former directors of the CBO, the OMB, the House and Senate Budget Committees and the Federal Reserve Board of Governors
- "*The Financial Condition and Fiscal Outlook of the U.S. Government*", a slide deck from David Walker, President of the Peter G Peterson Foundation and Former Comptroller General of the United States
- An IMF paper from April 2011, "*An Analysis of U.S. Fiscal and Generational Imbalances: Who Will Pay and How?*"
- An April 2011 piece from PIMCO's Bill Gross piece entitled "*Skunked*"
- A speech by Dallas Fed President Richard Fisher in May 2008 entitled "*Storms on the Horizon*"
- Perhaps the most thorough piece of all, a 460-slide behemoth entitled "*USA Inc*", distributed by venture capital firm Kleiner Perkins Caufield & Byers with an introduction from George Shultz, Paul Volcker, Michael Bloomberg, Richard Ravitch and John Doerr
- "*Republicans Repeat Medicare Mistake of 1965*", an editorial from Democratic Senator Bob Kerrey to the New York Times in 1995 on the government's decision to not impose cost controls on Medicare, a policy error Kerrey dates back to 1965, when the American Medical Association insisted on "usual and customary fees" in exchange for their support
- "*Measuring the Unfunded Obligations of European Countries*", Jagadeesh Gokhale, European Commission, European Economy Economic Papers, No. 297, December 2007; National Center For Policy Analysis, Policy Report No. 319, January 2009.

JSCDR	Joint Select Committee on Deficit Reduction
OCO	Overseas Contingency Operations
CBO	Congressional Budget Office
BCA	Budget Control Act
AMT	Alternative Minimum Tax
FEMA	Federal Emergency Management Agency
BIS	Bank for International Settlements

PREPARED STATEMENT OF ROGER C. ALTMAN

CHAIRMAN, EVERCORE PARTNERS

OCTOBER 5, 2011

Mr. Chairman and Members of the Subcommittee, thank you for inviting me to testify before you today on American fiscal policy.

You are holding this hearing at a time of serious economic and financial fragility for the United States. More than 2 years after the trough of the Great Recession (June 2009), our recovery has stalled and there is a serious threat of slipping back into negative growth. The sovereign debt crisis in Europe continues to rage, and that is undermining consumer, business and investor confidence. As a result of these two factors, severe and alarming strains have reemerged in our own financial system and in the global system.

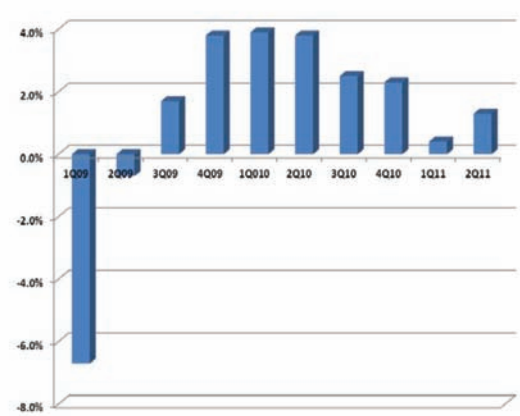
In other words, this is a dangerous moment from an economic and financial perspective. And, the decisions which the President and Congress make on fiscal policy over the short and medium term will play an important role in diminishing, or in worsening, those financial strains and our economic stability itself.

Economic and Financial Conditions Today

I want to spend a moment walking through this point on fragility.

First, the U.S. economy is threatened with renewed recession. It decelerated to an 0.8 percent growth rate during the first half of this year. That was down from 3.9 percent for the first half of 2010, as you can see in Table 1. Just a few negative developments, in financial markets, employment trends, or in overall confidence levels, could push this low growth rate into negative territory.

Table 1: GDP Growth



Source: Bureau of Economic Analysis

In addition, the present growth rate trend is far too slow to improve our struggling labor markets, given population growth. This is why net monthly job growth for the past three months has averaged only 35,000 new jobs, with zero jobs added in August.

The medium term outlook is also not encouraging. The latest IMF forecast for the U.S. economy over the second half of this year is a similarly meager 1.5 percent. And, the well regarded Goldman Sachs economic forecast is just slightly above that.

As for next year, Goldman Sachs' 2012 growth number is now down to 0.5 percent. And, in the face of such weakness, the U.S. unemployment rate will likely rise. That same forecast envisions an average 2012 unemployment rate of 9.4 percent. That is discouraging.

Further, the unemployment rate, while high, probably understates the real weakness in labor market conditions. The so-called underemployment rate (U-6) reflects those who have given up looking for work and those who work part time but would like a full time job. It presently stands at 16.2 percent, the highest since 1994.

Moreover, the labor participation rate, which just measures the percentage of working age adults with a job, is 64 percent currently. That is a 27 year low.

The latest Census Department data on poverty is also important, and it received too little attention. 15.3 percent of the American population, or 45 million people, now lives below the poverty line. The latter is defined as income of $22,000 or less for a family of four, excluding in-kind benefits like food stamps. This is the highest percentage of Americans in poverty in 28 years.

My point is that this is a poor overall economic picture. There are two main explanations. The aftermath of the credit market collapse of 2008, the second worst financial crisis in 100 years, is still restraining consumers. And likely will do so for another few years. Household balance sheets, which were severely overleveraged when the bottom fell out (debt at 140 percent of household income) have only returned halfway to historically average levels of debt.

More household deleveraging will occur, driven by the continuing weakness in home prices, weak incomes and overall economic insecurity. This is why the personal savings rate, at 4.5 percent, is so far above the negligible level of 3 years ago. Which, in turn, explains why consumer spending, which constitutes approximately 70 percent of U.S. GDP, is relatively stagnant.

The other major factor contributing to economic weakness is credit availability and lending volume. Total bank loans to commercial and industrial businesses are well below 2008 highs. Present outstandings are $1.29 trillion, as compared to the $1.61 trillion high. This reflects the bad combination of tighter lending standards and weak loan demand. The problem is that such low levels of borrowing are not consistent with a durable economic recovery.

These factors explain why, according to CBO, the country is "only halfway through the cumulative shortfall in output relative to its potential level" which will have resulted from the Great Recession. The total of that cumulative shortfall is estimated at $5 trillion.

Let me also comment on financial market conditions, starting with credit markets. Again, two main points. One is that the level of yields on U.S. Treasury securities is so low as to be nearly incomprehensible. Or the Treasury 10 year, for example, the yield is hovering around 1.80 percent. That is the lowest recorded level since the Federal Reserve System began publishing market data in 1953. And, it is a profoundly negative development. For, it signals negligible demand for capital and negligible inflation. These are hallmarks of recession.

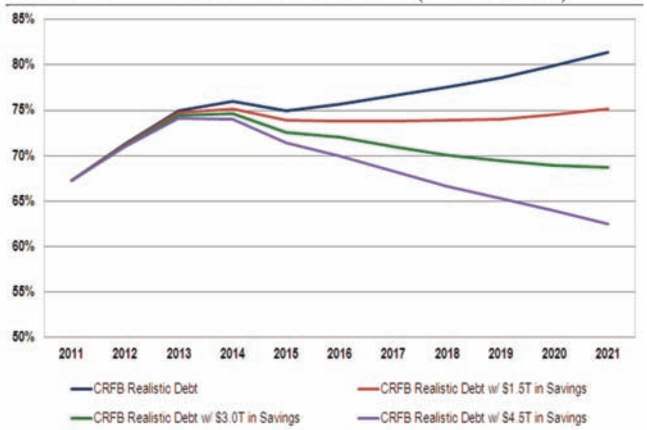
Second, the sovereign debt crisis in Europe, and the concomitant risk of a banking crisis there, has infected financial markets all around the world. Borrowing in public credit markets has recently become much more difficult. Stock prices have fallen nearly 20 percent since April, and equity financing levels have dropped accordingly. The window for initial public offerings, for example, has nearly closed. The fear factor which we saw so vividly in late 2008 and early 2009, has crept back into these markets. They are on a razor's edge.

Role of the Federal Deficit

The Members of this Committee, and all of your Congressional colleagues, should recognize that they will be making crucial decisions on deficit reduction in the midst of this economic and financial fragility. The right decisions can help to alleviate it. But, poor ones can worsen it, even to the point of serious crisis.

We all know that the U.S. is on the wrong track when it comes to deficits and debt. CBO recently projected that the amount of Federal debt held by the public will equate to 67 percent of U.S. GDP. That will be the highest ratio since 1951. Worse, CBO forecasts that, based on current policies, this proportion will be 82 percent by 2020. That would be the highest level incurred since record keeping began in 1792, excepting the period during and immediately after WWII. All of this is depicted in Table 2.

Table 2: Debt Paths Under Various Scenarios (Percent of GDP)



Source: The Committee for a Responsible Federal Budget, September 7, 2011 report, *What We Hope to See from the Super Committee*

The Federal debt grows, of course, in proportion to the size of the budget deficit. And, you well know that, in absolute terms, deficits hit all-time record highs in 2009 and 2010 and were still stratospheric at $1.3 trillion for the Federal fiscal year which ended a few days ago.

These deficits reflect a historically wide gap between spending and revenue levels. Federal spending has been hovering around 23 percent of GDP and revenue around a modern historic low of 16 percent. This seven point difference appears to be the largest in our modern history.

It is obvious that this mismatch, and the scary rate at which it is increasing our debt/GDP relationship, is not sustainable. Everyone agrees that, unchecked, it will reduce productivity, incomes and our standards of living. There is also reasonable agreement on the magnitude of deficit reduction which America needs to cure this disparity. The Bowles/Simpson Commission set a goal of stabilizing the debt/GDP ratio by 2015 and beginning to turn it downwards from there. The amount of 10 year deficit reduction necessary to achieve this approximates ($5 trillion).

Fortunately, the tide of public opinion has moved, and moved sharply on deficits and debt. It would seem that the basic wisdom of the American people has asserted itself. For, polls indicate that the public is deeply unhappy over continued, record deficits and the explosion in Federal debt, realizes the inherent dangers, and wants this path altered.

While this past summer's dispute over extending the Federal debt limit was difficult, it did provide a modest breakthrough. A 10-year package of specific deficit reduction actions totaling $917 billion was agreed then. And, the twelve member so-called Congressional Super Committee was established. It is charged, as we all know, with devising an additional $1.5 trillion program of deficit reduction actions and submitting them to the full Congress by November 23. If the Super Committee cannot agree on a package, or the Congress votes down its recommendations, then $1.2 trillion of reductions in domestic discretionary spending over 10 years will be automatically triggered. Essentially, these would take effect in 2013 and cuts would be divided equally between the defense and nondefense portions of the budget.

All of this means that a minimum of $2 trillion in 10-year deficit reduction actions will be set motion by the end of this year. That is a good start but not enough. Further, difficult decisions by the Super Committee, the full Congress and the President would be necessary to properly adjust U.S. fiscal policy.

A Growth and Jobs Initiative

The economic slowdown and recession risk which I initially discussed represents a huge short term risk. Slipping back into negative growth, and seeing the unemployment rate rise again, would deliver a psychological blow to consumers, businesses and financial markets. They could retrench further and a downward economic and financial spiral could result. And, that could occur when the fiscal and monetary authorities are largely out of ammunition.

Therefore, it makes sense to undertake a short term, entirely temporary growth and jobs agenda. This would represent a form of insurance policy.

President Obama has proposed a $447 billion program of tax cuts, infrastructure spending and extended unemployment insurance benefits. The core element is a deeper 1-year extension of the 2010 payroll tax cut for employees and a similar 1-year payroll tax cut for small businesses.

In my view, the President's proposal is a sound one. And, it is clear to me that such actions, like the 2009/2010 stimulus program, would have a beneficial economic impact. But, there also are numerous, possible variations on the President's package. The point is that a short term growth and jobs package of this approximately magnitude should be undertaken now. Economic conditions demand it, and financial markets would welcome it.

Long Term Deficit Reduction

At this very moment, financial markets are pre-occupied with the European Sovereign debt crisis and the risks of renewed recession in the U.S. and Europe. That is why yields on U.S. Treasury securities, and German and British government bonds, are at all-time lows. Concerns over the long term deficit outlook, poor as it is, are secondary.

But, such views can change in an instant. It is just a matter of time before financial markets again are preoccupied with the threatening U.S. fiscal outlook.

At that point, the trajectory of interest rates will reverse itself. After all, the 10-year average yield on 10-year U.S. Treasuries is nearly three times the present yield. Then, if our deficits actually follow the CBO path, exceeding 80 percent of GDP, family incomes would be lower, productivity would be lower and our standards of living would be lower. That is not an acceptable outcome, which is why a major, long term deficit reduction package is necessary.

There are three possible outcomes for the Super Committee process. The first is, unfortunately, the most widely expected result. Namely, that the Committee cannot find a majority to support the necessary $1.5 trillion package of reductions and does not submit a recommendation to the full Congress. On that basis, the so-called trigger would be pulled, and $1.2 trillion of discretionary spending reductions would be initiated.

This outcome would be disappointing across the board. It would vividly underscore an inability to address such a fundamental and important problem. And, if financial markets were as unstable then as they are now, this outcome also could further destabilize them. I would urge the Members of the Committee to work with other Senators to avoid this disappointment.

The second outcome would involve the Super Committee finding a majority on a credible $1.5 trillion deficit reduction package, submitting the related recommendations to the full Congress and having those pass and become law. This would send a reassuring signal to the public, and to the business and financial communities. At a time of such economic and financial weakness, this would be particularly helpful.

The third outcome, albeit unlikely, would be the optimal one. This is the "Go Big" scenario under which the Super Committee reaches agreement, on a much larger, and balanced package of deficit reduction actions. In effect, it solves the debt/GDP problem in one fell swoop with a $3–4 trillion 10-year agreement along the lines of Bowles/Simpson. And, one which wins the support of President Obama and a majority of the full Congress.

Provided that this did not take effect too quickly in such a weak economic environment, this is just the type of solution which could shore up consumer and business confidence, reassure financial markets and begin to restore public faith in Government itself.

PREPARED STATEMENT OF DOUGLAS HOLTZ-EAKIN

PRESIDENT, AMERICAN ACTION FORUM

OCTOBER 5, 2011

Introduction

Chairman Tester, Ranking Member Vitter, and Members of the Subcommittee thank you for the privilege of appearing today. In this short statement,* I wish to make the following points:

- The outlook for deficits and debt threatens the Nation's prosperity and freedom. Changing the fiscal course should be our top national priority.
- Controlling the growth of future Federal spending should be the central objective of policy makers in pursing this goal. Effectively controlling spending, reducing deficits, and eliminating future debt accumulation can aid near-term economic growth.
- Businesses, entrepreneurs, and investors perceive the future deficits as an implicit promise of higher taxes and higher interest rates.
- There are no fixed statistical indicators that will signal imminent loss of confidence in the U.S. by global capital markets, but Federal debt is already in the danger zone.

Let me discuss each in turn.

The Threat of Future Debt

The Fiscal Outlook. The Federal Government faces enormous budgetary difficulties, largely due to long-term pension, health, and other spending promises coupled with recent programmatic expansions. The core, long-term issue has been outlined in successive versions of the Congressional Budget Office's (CBO's) *Long-Term Budget Outlook.*[1] In broad terms, over the next 30 years, the inexorable dynamics of current law will raise Federal outlays from an historic norm of about 20 percent of Gross Domestic Product (GDP) to anywhere from 30 to 40 percent of GDP. Any attempt to keep taxes at their postwar norm of 18 percent of GDP will generate an unmanageable Federal debt spiral.

This depiction of the Federal budgetary future and its diagnosis and prescription has all remained unchanged for at least a decade. Despite this, action (in the right direction) has yet to be seen.

Those were the good old days. In the past several years, the outlook has worsened significantly.

Over the next 10 years, according to the Congressional Budget Office's (CBO's) analysis of the President's Budgetary Proposals for Fiscal Year 2012,[2] the deficit would never fall below $750 billion. Ten years from now, in 2021, the deficit would be 4.9 percent of GDP, roughly $1.2 trillion, of which over $900 billion would be devoted to servicing debt on previous borrowing.

As a result of the spending binge, in 2021 public debt would have more than doubled from its 2008 level to 90 (87.4) percent of GDP and will continue its upward trajectory.

The "Bad News" Future under Massive Debt Accumulation. A United States fiscal crisis is now a threatening reality. It wasn't always so, even though—as noted above—the Congressional Budget Office has long published a pessimistic *Long-Term Budget Outlook.* Despite these gloomy forecasts, nobody seemed to care. Bond markets were quiescent. Voters were indifferent. And politicians were positively in denial that the "spend now, worry later" era would ever end.

Those days have passed. Now Greece, Portugal, Spain, Ireland, and even Britain are under the scrutiny of skeptical financial markets. And there are signs that the U.S. is next. The Federal Government ran a fiscal 2010 deficit of $1.3 trillion—nearly 9 percent of GDP, as spending reached nearly 24 percent of GDP and receipts fell below 15 percent of GDP.

What happened? First, the U.S. frittered away its lead time. It was widely recognized that the crunch would only arrive when the baby boomers began to retire. Guess what? The very first official baby boomer already chose to retire early at age

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*The opinions expressed herein are mine alone and do not represent the position of the American Action Forum. I thank Cameron Smith for her assistance.

[1] Congressional Budget Office. 2011. "The Long-Term Budget Outlook". Pub. No. 4277. *http://www.cbo.gov/ftpdocs/122xx/doc12212/06-21-Long-Term_Budget_Outlook.pdf*

[2] Congressional Budget Office. 2011. "An Analysis of the President's Budgetary Proposals for Fiscal Year 2012". Pub. No. 4258. *http://www.cbo.gov/ftpdocs/121xx/doc12130/04-15-AnalysisPresidentsBudget.pdf*

62, and the number of retirees will rise as the years progress. Crunch time has arrived and nothing was done in the interim to solve the basic spending problem—indeed the passage of the Medicare prescription drug bill in 2003 made it worse.

Second, the events of the financial crisis and recession used up the Federal Government's cushion. In 2008, debt outstanding was only 40 percent of GDP. Already it is over 60 percent and rising rapidly.

Third, active steps continue to make the problem worse. The Affordable Care Act "reform" adds two new entitlement programs for insurance subsidies and long-term care insurance without fixing the existing problems in Social Security, Medicare, and Medicaid.

Thus, the U.S. faces squarely a future that potentially includes sufficient Federal indebtedness to generate sovereign debt distress. What is at stake for the average citizen?

For Main Street America, the "bad news" version of the fiscal crisis occurs when international lenders revolt over the outlook for debt and cut off U.S. access to international credit. In an eerie reprise of the recent financial crisis, the credit freeze would drag down business activity and household spending. The resulting deep recession would be exacerbated by the inability of the Federal Government's automatic stabilizers—unemployment insurance, lower taxes, *etc.*—to operate freely.

Worse, the crisis would arrive without the U.S. having fixed the fundamental problems. Getting spending under control in a crisis will be much more painful than a thoughtful, proactive approach. In a crisis, there will be a greater pressure to resort to damaging tax increases. The upshot will be a threat to the ability of the United States to bequeath to future generations a standard of living greater than experienced at the present.

Future generations will find their freedoms diminished as well. The ability of the United States to project its values around the globe is fundamentally dependent upon its large, robust economy. Its diminished state will have security repercussions, as will the need to negotiate with less-than-friendly international lenders.

The "Good News" Future under Massive Debt Accumulation. Some will argue that it is unrealistic to anticipate a cataclysmic financial market upheaval for the United States. Perhaps so. But an alternative future that simply skirts the major crisis would likely entail piecemeal revenue increases and spending cuts—just enough to keep an explosion from occurring. Under this "good news" version, the debt would continue to edge northward—perhaps at times slowed by modest and ineffectual "reforms"—and borrowing costs in the United States would remain elevated.

Profitable innovation and investment will flow elsewhere in the global economy. As U.S. productivity growth suffers, wage growth stagnates, and standards of living stall. With little economic advancement prior to tax, and a very large tax burden from the debt, the next generation will inherit a standard of living inferior to that bequeathed to this one.

Controlling Spending To Reduce Deficits and Debt

The policy problem facing the United States is that spending rises above any reasonable metric of taxation for the indefinite future. Period. There is a mini-industry devoted to producing alternative numerical estimates of this mismatch, but the diagnosis of the basic problem is not complicated. The diagnosis leads as well to the prescription for action. Over the long-term, the budget problem is primarily a spending problem and correcting it requires reductions in the growth of large mandatory spending programs and the appetite for Federal outlays, in general.

As an example, using the President's 2012 Budget, the CBO projects that over the next decade the economy will fully recover and revenues in 2021 will be 19.3 percent of GDP—over $300 billion more than the historic norm of 18 percent. Instead, the problem is spending. Federal outlays in 2021 are expected to be 24.2 percent of GDP—about $1 trillion higher than the 20 percent that has been business as usual in the postwar era.

Just as some would mistakenly believe that the Federal Government can easily "tax its way out" of this budgetary box there is an equally misguided notion in other quarters that it can "grow its way out." The pace of spending growth simply must be reduced.

Most importantly, mandatory spending programs cannot be left to evolve as dictated by current law. It is equally important to quickly undertake entitlement reform. To see the need for urgency, consider first Social Security.

Social Security contributes to the current deficit. At present, Social Security is running a modest cash-flow deficit, increasing the overall shortfall. As the years progress, these Social Security deficits will become increasingly larger. They are central to the deficit outlook. More importantly, the stream of future outlays is heavily driven by demography. In particular, if the future benefits of the baby boom generation are exempted from reform, either by design or a failure to move quickly, then the outlay "problem" will have been effectively exempted from reform. This would be a fundamental policy failure.

For these reasons, an immediate reform and improvement in the outlook for entitlement spending would send a valuable signal to credit markets and improve the economic outlook.

Naturally, it would be desirable to focus on the larger future growth in outlays associated with Medicare, Medicaid, and the Patient Protection and Affordable Care Act (ACA). These share the demographic pressures that drive Social Security, but include the inexorable increase in health care spending per person in the United States. From a policy perspective, it would be desirable to replace the ACA with reforms that raised the efficiency of health care spending and slowed the growth of per capita health care outlays. At the centerpiece of such reforms would be reforms to the Medicare and Medicaid programs. However, in the absence of a political consensus to revisit the ACA, Medicare and Medicaid reforms will remain paralyzed and the most promising area for bipartisan entitlement reform is Social Security.

The Economics of Spending Control

The top issue facing Americans is the need for robust job growth. According to the National Bureau of Economic Research the recession began in December 2007. Their data show that there were 142.0 million jobs in December of 2007—the average of payroll and household survey data. In June 2009, NBER's date for the end of the recession, the same method showed 135.3 million jobs, for a total job loss of 6.7 million attributed to the recession. These numbers are quite close to those using the Bureau of Labor Statistics nonfarm payroll data, which showed a loss of 6.8 million.

There are glimmers of promise. Since December 2009, 1.8 million payroll employment jobs have been added. However at the same time, there are 14 million unemployed persons in the economy and many more discouraged workers. Since the start of the recession the labor force has fallen nearly 535,000.

For these reasons, the current unemployment rate of 9.1 percent likely understates the real duress. Using the BLS alternative unemployment rate (U-6), one finds that unemployed, underutilized and discouraged workers are 16.2 percent of the total. As evidence of the difficulties, the number of long-term unemployed (27 weeks or more) is currently 6 million and accounts for 43 percent of all unemployed persons.

The fiscal future outlined above represents a direct impediment to job creation and growth. The United States is courting continued downgrade as a sovereign borrower and a commensurate increase in borrowing costs. In a world characterized by financial market volatility stemming from Ireland, Greece, Portugal, and other locations this raises the possibility that the United States could find itself facing a financial crisis. Any sharp rise in interest rates would have dramatically negative economic impacts; even worse an actual liquidity panic would replicate (or worse) the experience of the fall of 2008.

Alternatively, businesses, entrepreneurs and investors perceive the future deficits as an implicit promise of higher taxes, higher interest rates, or both. For any employer contemplating locating in the United States or expansion of existing facilities and payrolls, rudimentary business planning reveals this to be an extremely unpalatable environment.

In short, cutting spending is a pro-growth policy move at this juncture. As summarized by recent American Action Forum research, the best strategy to both grow and eliminate deficits is to keep taxes low and reduce public employee costs and transfer payments. [3]

Keynesian Arguments and Reducing Spending. Analyses of H.R. 1, the continuing resolution that called for $61 billion in reduced Federal spending, by Goldman Sachs and Economy.com have been touted by some as evidence that it is not feasible to engage in spending reductions. Similarly, one hears frequently that the Budget Control Act of 2011 runs the risk of choking off the recovery.

I believe these arguments miss several key points.

Begin, for illustration, with the debate surrounding the CR. The first thing to note is that while Members are aware that a reduction of $61 billion in budget authority does not translate into an immediate $61 billion cut in outlays, many analysts appear to not understand these budgetary facts. Indeed, on average, a $1 cut would translate into only 52 cents during the current fiscal year.

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[3] *See, http://americanactionforum.org/news/repairing-fiscal-hole-how-and-why-spending-cuts-trump-tax-increases.*

To generate their estimates, Goldman Sachs assumed outlay reductions of $15 billion in the 2nd quarter and $30 billion in the 3rd quarter of calendar 2011. Naively interpreted, this could produce noticeable impacts on quarter-to-quarter GDP growth. But this is a misleading and highly overstated estimate of the likely impact because:

- The CBO estimates an outlay reduction of only $9 billion in fiscal 2011, or an impact of at most 0.3 percentage points;
- The calculation assumes full dollar-for-dollar reduction in GDP as spending declines. This is too large, especially because;
- Not all outlay reductions are actual cuts in the purchases of goods and services to contribute to measured GDP. Instead, some are transfers payments to States or individuals that will have a more muted impact. Indeed, while FY2010 showed outlays of $3,456 billion on a budget basis, the National Income and Product Accounts [4] showed under 30 percent ($1,030 billion) as consumption purchases;
- Not all of the budget authority cuts are from new spending. Instead, some are rescissions of the authority for spending that never occurred and might never occur; and
- Most importantly this is a static calculation that assumes no beneficial offset in private sector spending because of the improved budget outlook and prospect of lower future taxes and interest rates. Put differently, the criticisms ignore the rationale for making these beneficial cuts to begin with: to clear the way for private sector jobs and growth.

A different way to make the last point is to note that these "Keynesian" arguments invoke a sterile, mechanical view of his economic views. In fact, Lord Keynes placed considerable importance on the role of expectations and optimism regarding the economic environment—so-called animal spirits. Policies that enhance the willingness and desirability of businesses to invest fit neatly in to his view of business cycles and economic growth.

Similar considerations apply to the recently enacted Budget Control Act of 2011. Much publicity has accompanied the discretionary caps in the bill, which "cut" over $800 billion in budget authority relative to CBO's adjusted 2011 baseline. In reality, no such cuts have yet taken place, as the FY2012 appropriations have not yet been completed. Moreover, the future "cuts" imposed by the caps are only as concrete as the collective will of future Congresses and Administrations to impose them.

In this light, it is interesting to examine recent movements in indexes of economic confidence ranging from small businesses, to CEOs, to households (see Table).

Measures of Economic Confidence

	2010	2011											
	Sep	***Oct***	***Nov***	***Dec***	***Jan***	***Feb***	***Mar***	***Apr***	***May***	***June***	***July***	***Aug***	***Sep***
NFIB Small Business Optimism Index[1]	89	91.7	93.2	92.6	94.1	94.5	91.9	91.2	90.9	90.8	89.9	88.1	NA
Chief Executive CEO Confidence Index[2]	4.9	5.1	5.8	5.8	6.3	6.4	6	6.2	6.1	5.4	5.3	5.3	NA
Reuters/Michigan Survey of Consumer Sentiment[3]	68.2	67.7	71.6	74.5	74.2	77.5	67.5	69.8	74.3	71.5	63.7	55.7	57.8

[1]http://www.nfib.com/Portals/0/PDF/sbet/sbet201102.pdf
[2]http://www.bloomberg.com/apps/quote?ticker=CEOCINDX:IND
[3]https://customers.reuters.com/community/university/

[4] Congressional Budget Office. 2011. "CBO's Projections of Federal Receipts and Expenditures in the Framework of the National Income and Product Accounts". Pub. No. 4250.

No definitive explanation of month-to-month movements in measures of confidence will emerge from this hearing. However, one could make the case that markedly as the election and Congressional debate shifted toward control of future spending, deficits, and debt. Unfortunately, with the passage of a Budget Control Act that revealed partisan differences and less-than-definitive commitments to reduced spending, confidence tailed. Off.

Two final aspects of the recent, Keynesian-based opposition to controlling spending are perplexing. Often those who make the claim that, for example, a $61 billion cut in spending will endanger the recovery are equally willing to argue that tax increases are needed to close the deficit. However, in a Keynesian model tax increases and transfer decreases enter in exactly the same manner. If the latter endanger the recovery, so must the former!

More importantly, entitlement reform—the repeal of the Affordable Care Act, Medicare reform, Medicaid reform, or Social Security reform—is likely to have no immediate impact on Federal outlays. Instead, they are commitments in the present to reduced spending in the future. By construction, they can have no negative, Keynesian impacts on recovery. Instead, they carry only beneficial impacts on the expectations of employers and other market participants.

The Role of Tax Policy

While it will not be possible or desirable to rely on pure revenue increases to address the looming debt explosion, there is a role for improved tax policy to support economic growth. What is needed now is a tax policy that has incentives for businesses and entrepreneurs to locate in America and spend at a faster rate on innovation, workers, repairs, and new plants and equipment.

The place to start is the corporate income tax, which harms our international competitiveness in two important ways. First, the 35 percent rate is far too high: when combined with State-level taxes, American corporations face the highest tax rates among our developed competitors.[5] The rate should be reduced to 25 percent or lower.

Second, the United States remains the only developed country to tax corporations based on their worldwide earnings. Our competitors follow a territorial approach in which, say, a German corporation pays taxes to Germany only on its earnings in Germany, to the U.S. only on its earnings here, and so forth. If we were to adopt the territorial approach, we would place our firms on a level playing field with their competitors.

Proponents of the worldwide approach argue that because it doesn't let American firms enjoy lower taxes when they invest abroad, it gives them no incentive to send jobs overseas. Imagine two Ohio firms, they say: one invests $100 million in Ohio, the other $100 million in Brazil. The worldwide approach treats the profits on these two investments equally, wisely giving the company that invests in Brazil no advantage over its competitor.

But this line of reasoning ignores three points. First, because firms all over the world will pay lower taxes than the two Ohio companies, the likeliest outcome of the scenario is that both firms will fail, unable to compete effectively with global rivals. Second, when American multinational firms invest and expand employment abroad, they tend also to invest and expand employment in the United States. In the end, healthy, competitive firms grow and expand, while uncompetitive firms do not, meaning that our goal should be to make sure that American companies don't end up overtaxed, uncompetitive, and eventually out of business. And finally, because the U.S. is the holdout using a worldwide approach, it is at a disadvantage as the location for the headquarters of large, global firms. As the U.S. loses the headquarters, it will lose as well the employment, research and manufacturing that typically is located nearby.

The corporate tax should be reformed further. At present, companies must depreciate their capital purchases over time. Instead, they should be allowed to deduct immediately the full cost of all investments, which would provide a dramatic incentive for spending. We should also consider phasing out the tax-deductibility of the interest that companies pay on their borrowing. Because this interest is deductible and the companies' own dividends are not, firms have an incentive to borrow excessively. Removing that incentive—making a firm's tax liability dependent not on its

[5] Some defend the high corporate tax rate by arguing that the effective corporate tax rate is much lower. This misses an important point. Every country's effective tax rate is also lower than its statutory rate. A recent study by two economists at the University of Calgary *(http://www.cato.org/pubs/tbb/tbb_64.pdf)* concludes that the marginal tax rate in the U.S on new investment is 34.6 percent, higher than any other country in the OECD.

financial decisions but on its real economic profitability—would discourage financial engineering and focus corporations on their core mission.

A more competitive corporate-tax system would be a good start in our effort to encourage private-sector growth. But a lot of private-sector economic activity in the U.S. isn't affected by the corporate tax at all. Activity that takes place in sole proprietorships, partnerships, and other "pass-through entities"—organizations whose income is treated solely as that of their investors or owners—is instead affected by the individual income tax. Congress' Joint Committee on Taxation projects that in 2011, $1 trillion in business income will be reported on individual income-tax returns.

It's important to note that nearly half of that $1 trillion—$470 billion—will be reported on returns that face the top two income-tax rates. A conservative estimate is that more than 20 million workers would be employed by firms directly affected by those two tax rates. Tax reform should avoid higher marginal tax rates in favor of lower rates and a broader base. Marginal tax rates and the taxation of dividends and capital gains directly affect companies' decisions about innovation, investment, and savings.

Americans—from homeowners to small businesspeople to the millions of unemployed—are in desperate need of faster and prolonged economic growth. Congress should therefore evaluate tax proposals based on whether they're likely to trigger and support that growth. Tax policy can play a key role in spurring an economic recovery—but not without sustained reform of both the corporate and individual income-tax systems.

The Need for Rapid Action

Financial markets no longer can comfort themselves with the fact that the United States has time and flexibility to get its fiscal act together. Time passed, wiggle room vanished, and prior to 2011 the only actions taken have made matters worse.

There are already warning signs on the horizon. S&P has chosen to lower the Federal credit rating. While there has been much discussion about the timing of the downgrade and the source of the downgrade, there should be little dispute regarding the substance of the critique.

Consider, for example, the analysis by Moody's. As outlined in a report,[6] the credit rating agency Moody's looks at the fraction of Federal revenues dedicated to paying interest as a key metric for retaining a triple-A rating. Specifically, the large, creditworthy sovereign borrowers are expected to devote less than 10 percent of their revenues to paying interest. Moody's grants the U.S. extra wiggle room based on its judgment that the U.S. has a strong ability to repair its condition after a bad shock. The upshot: no downgrade until interest equals 14 percent of revenues.

This is small comfort as the 2012 Obama Administration budget targets 2015 as the year when the Federal Government crosses the threshold and reaches 14.2 percent. Moreover, the plan is not merely to flirt with a modest deterioration in creditworthiness. In 2021, the ratio reaches 20.3 percent. The Budget Control Act and actions of the Joint Select Committee on Deficit Reduction are intended to alter this trajectory, but until their intended actions become budgetary fact, international markets will likely remain wary.

Conclusion

At this juncture, the United States needs a keen focus on enhancing the rate of economic growth. Workers and economy as a whole will benefit from pro-growth policies. Central aspects of a pro-jobs and growth agenda are controlling Federal spending growth; eliminating the potential for debt accumulation that generates a fiscal crisis, or higher taxes and interest rates; and improved tax policy.

I look forward to answering your questions.

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[6] Moody's determines debt reversibility from a ratio of interest payments to revenue on a base of 10 percent. Wider margins are awarded to various governments to indicate the additional "benefit of the doubt" Moody's awards. The U.S. finds itself on the upper end at 14 percent. The ratios are "illustrative and are not hard triggers for rating decisions." *See: Aaa Sovereign Monitor Quarterly Monitor No. 3.* Moody's Investor Service. March 2010.

PREPARED STATEMENT OF WILLIAM JOHNSTONE

PRESIDENT AND CHIEF EXECUTIVE OFFICER, DAVIDSON COMPANIES

OCTOBER 5, 2011

Chairman Tester, Ranking Member Vitter, and Members of the Subcommittee, my name is Bill Johnstone. I am the President and Chief Executive Officer of Davidson Companies.

Davidson is an employee-owned financial services holding company, headquartered in Great Falls, Montana. We have been in business for 76 years, have 1,100 employees and operate in 16 States, primarily west of the Mississippi.

Davidson has three principal lines of business:

- We provide investment advice and products to approximately 120,000 individual and institutional investors.
- We provide institutional research for approximately 260 companies and make markets in approximately 425 stocks (mostly small and mid-cap companies). We also trade stocks with institutional investors and provide underwriting and investment banking advisory services to small and mid-cap companies.
- Last, we trade tax-exempt and taxable bonds with institutional investors and underwrite bonds for and provide advisory services to Government units throughout the Western United States.

We are not a commercial bank or depository institution and we do not originate or underwrite mortgages or mortgaged backed securities or engage in proprietary trading or the creation of or trading in complex derivatives. We have never received a Government bailout. In the past 10 years, in the context of challenging financial markets and economic conditions and the demise or consolidation of many financial services firms, we have remained independent and doubled in size.

In contrast to the other panelists, I am not an economist, nor do I have significant prior academic or Government experience in analyzing or developing tax or economic policy. Prior to my current position, I practiced finance law, managed an international law firm and was the CEO of a regional securities firm in the Southwest.

My views and observations regarding the deficit are shaped and informed by my experiences, particularly my recent experience at Davidson.

In my position, I talk either directly or through our employees with a range of investors and businesses. These include retirees, small business persons, families saving for retirement and college education, businesses trying to raise capital, commercial bank clients, institutional investors from small to large and State and local governmental units that access the bond market. I also speak with colleagues in other similar financial services firms.

I want to make clear that my views and observations do not necessarily represent those of Davidson, its employees or clients.

My larger views and observations are not materially different from those espoused by many others. Perhaps some of my sources and reasoning are and will be helpful.

I want to discuss three key points:

- There is considerable investor concern about the Federal deficit and our ability or will to address it. The concern is negatively influencing the ability of investors and businesses to make business and investment decisions necessary to drive economic growth and job creation.
- Policies to address the deficit should be bold, concrete, and credible, but implementation should be staged to avoid exacerbating the current weakness in the economy. While the particulars of the solution are important, more important is that the development and implementation of a solution is credible and understood. In this situation, perfection, as defined by narrow self-interest, is the enemy of the good.
- To the extent the solution involves changes in tax policy, as I believe it should, we should use this as an opportunity to commence reform of our Federal tax laws.

Historically, the Federal deficit and its implications were not frequently voiced investor concerns. At least three developments have occurred to change it. The growth in the deficit's size (absolutely and relatively), this summer's highly publicized debt limit debate and the financial crisis in Europe. Most investors, whether institutional or individual, have concluded that the deficit, and as important its projected growth, will result in substantial damage to our economy unless we make meaningful changes. The situation in Europe has heightened awareness of the economic implications of fiscal deficits and the difficulty of addressing them, particularly if responses are delayed. At the same time, the length and nature of the debt limit debate raises serious questions among investors and business persons as to whether Government has the ability to develop and implement a deficit solution.

Certainly, the deficit is not the only factor inhibiting economic growth and, at present, maybe not the most important factor. The continuing difficulties in the housing market, high unemployment, the apparent increase in regulatory burden and general deleveraging by consumers and business are among other important factors that I frequently hear in my discussions. But the deficit and the uncertainty of whether and how it will be addressed are critical factors in reducing investor and business confidence and willingness to take risk and make business and investment decisions necessary to drive economic growth and job creation. I consistently hear that from investors and businesses and their representatives and I see it in their behavior.

The financial system is short of neither capital nor liquidity to fund economic growth. The financial system, businesses and the consumer are short of confidence and much of this deficit in confidence is related to the Federal deficit.

I am not here to offer a recommendation regarding the details of a policy response to address the deficit. There is a plethora of reasonable potential responses, including those suggested or discussed by the other panelists. I happen to believe the Simpson-Bowles Commission offered a number of thoughtful and sensible suggestions and provides a very good starting point. However, I will share my views regarding what I believe are three important elements of a solution.

First, I would be an advocate of a larger rather than smaller reduction target more in the range of the Simpson-Bowles suggestions, for a couple of reasons. I think it better addresses the issue. And, it reflects my skepticism regarding the ultimate outcome of the legislative process and the natural inclination to develop overly optimistic projections of future revenue growth and expense reduction.

Second, as has been oft noted by others more expert than I, the desire (perhaps zeal) to make a meaningful and quick reduction in the deficit has to be balanced with the realities of the current economic situation and the scope and economic impact of the policy changes. The required changes necessarily will be profound in their scope and impact. They have to be evolutionary, not revolutionary. While implementation of a plan should be staged, the plan should be agreed to sooner than later. The longer we wait the more costly the solution, the more limited the policy options and the more damage arising from the current uncertainty.

Last, I am struck by the difference in the narrative I hear in my conversations with employees, clients and business persons and the narrative I hear from Washington, DC. My audience is probably somewhat older and more conservative than the general populace. And certainly, there are significant differences of opinion. However, in general, the narrative I hear is more pragmatic, balanced and in my view sensible relative to the range of appropriate policy options. And, the narrative reflects an acknowledgement that change is necessary and that it will require some sacrifice and loss of benefit or advantage that is conferred by existing policy.

I will only briefly note my belief that any deficit reduction plan should include some effort to reform our Federal income tax, both corporate and individual. I am skeptical that the necessary deficit reduction can be accomplished entirely on the expense side or that some increase in revenue will materially damage our economic prospects, and I would not approach the issue on the condition that revenue cannot or should not be increased. However, regardless of how you stand on that point, we need to move to a tax code that is simpler and fairer, with lower marginal rates and with far fewer deductions and exemptions. The proliferation of targeted deductions, exemptions or distinctions in sources of income too often distorts rational economic and business decision making and should be reversed. This has been a widely held policy goal for decades. Perhaps the reality of our current challenges will produce the will to do something.

Thank you for allowing me to share my thoughts on this important topic.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

STATEMENT SUBMITTED BY ROBERT L. REYNOLDS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, PUTNAM INVESTMENTS, AND PRESIDENT OF THE PUTNAM FUNDS

I am Robert L. Reynolds, president and chief executive officer of Putnam Investments and president of the Putnam Funds. My thanks to the Subcommittee for inviting me to share with you our concerns about an issue directly related to ongoing efforts to curb Federal deficits: the need to also preserve, indeed extend, incentives for retirement savings in America.

Even as we struggle to bring our deficits down and get our national debt back onto a sustainable path, I believe that savings, and retirement savings specifically have a vital role to play in a transition that America absolutely has to make. Simply put, our Nation needs to move away from rising debt, leverage and debt-driven consumption to a new economic model, grounded on higher savings, and greater incentives for investment, business formation and job creation. Ultimately, the best way to deal with our deficits and debt will be to outgrow them. Robust retirement savings will be key to spurring such renewed growth. National solvency and personal solvency go hand in hand. Economic policy should never pit one against the other.

Regrettably, though, there is a real risk that incentives for companies to offer workplace savings plans and for individuals to participate in them could be undermined by ill-considered policy changes aimed at reducing the budget deficit.

Proposals to cap or roll back tax deferrals for retirement savings are particularly dangerous. If adopted, they could have the effect of reversing a generation's worth of Congressionally driven progress on retirement savings. They would undercut incentives for thousands of small and emerging companies to offer their workers retirement plans at all, and could send millions of future workers toward retirement with no access to workplace savings plans. Moreover, cuts to current retirement savings initiatives would likely return far less revenue to Treasury than their proponents estimate—even over the short-term—while placing millions of future retirees at risk.

The background to this policy debate is well known. Americans today live longer, more active lives; the cost of health care, especially in later life, has increased dramatically; traditional pension plans have declined in number and scope, and only a small fraction of today's workers participate in them. Meanwhile, Social Security's projected ability to replace preretirement income is declining, even under current law, as a result of rising eligibility age and the costs of Medicare deductions.

To supplement these dwindling sources of assured retirement income, working Americans have come to rely on a broad spectrum of retirement savings programs that Congress has created over the past several decades. These include individual retirement accounts (IRAs); defined-contribution savings vehicles, including 401(k), 403(b) and 457 plans; and tax-advantaged variable annuities. These programs have enabled millions of workers and their families to enjoy more secure, dignified retirements. While they can—and should—be improved on, these programs represent a major, made-in-America success story.

A study of the retirement readiness of nearly 3,300 working Americans sponsored by Putnam Investments and Brightwork Partners earlier this year underscores the importance of workplace savings programs as a vital adjunct to Social Security. The study found that working Americans overall are on track to replace 64 percent of their current income in retirement. This is somewhat short of what they are likely to need but close enough so that most people—though not all—can still achieve secure retirements if they act now to raise savings.

The details of these findings are particularly revealing. Including future Social Security benefits, the best-prepared quartile of working Americans is on track to replace 100 percent of current income in retirement. The least-prepared quartile is on track to replace just 46 percent of preretirement income. Yet the mean household income of both groups is an identical $93,000.

What accounts for this vast difference in retirement readiness? Several factors stand out, but one in particular appears crucial: The very best-prepared Americans—roughly 19 million workers according to Brightwork estimates—both enjoy access to a 401(k) or other defined-contribution plan at work and contribute 10 percent or more of their income to their plan. In other words, today's existing 401(k) plan structure can deliver solid retirement security for those workers who make the decision to take part and who also defer 10 percent of more of their salaries. In effect, we have discovered an antidote to the risk of elderly poverty—and it has three simple ingredients: access to a workplace savings plan, the decision to save; and willingness to defer at rates of 10 percent of more.

Precisely because the results they can deliver are so clearly in the public interest, today's retirement savings programs were given the advantage of deferring Federal income taxes in the first place. Tax deferrals offer a powerful incentive for workers to maximize their savings. They have contributed greatly to the success of these plans. Today, roughly 70 percent of American families have tax-advantaged retirement savings, and assets held in employer-sponsored retirement plans, IRAs and annuities totaled $17.5 trillion at year end 2010. (Source: 2011 Investment Company Fact Book, pages 100–102: *http://www.ici.org/pdf/2011_factbook.pdf.*)

Building on these programs, improving them and extending them to the tens of millions of Americans who lack access to on-the-job savings plans should be among our most important national goals. That is why I believe that Congress should not only preserve all existing savings incentives, but support solid, bipartisan ideas such as the Auto-IRA, which would extend access to workplace savings coverage for the many millions of workers who currently lack such on-the-job plans.

Well-intentioned but misguided advocates for reducing the Federal budget deficit would take the Nation in the opposite direction by seeking to cut back the tax advantages that help drive retirement savings. The rationale behind such proposals is that the tax deferrals at the heart of 401(k) plans and similar savings vehicles represent tax "expenditures" that significantly reduce needed tax revenue. Nothing could be further from the truth. Retirement savings deferrals are not permanent tax expenditure at all, but only temporary postponements of tax obligations. When retirement savings are drawn down, the money is taxed as ordinary income, even though the retirement accounts themselves are typically composed mostly of long-term capital gains.

Equally misleadingly, the Congressional Budget Office uses a 10-year window for analyzing the costs of tax deferrals. As a result, it cannot accurately measure the true cost of tax provisions that are incurred over the periods of decades that make up the typical worker's career. Today's tax deferrals are counted as revenue losses, but the taxes that will be paid beyond a decade forward not counted at all. This practice distorts the true "full-lifecycle" costs of these incentives, understates their social and economic benefits and overstates the revenue that would be generated by cutting back on them.

Workplace-based retirement programs are particularly beneficial for lower- and middle-income workers. Research by the American Society of Pension Professionals & Actuaries found that households with annual incomes below $100,000 pay 26 percent of income taxes but receive 62 percent of the benefit from 401(k) plans. In contrast, families earning more than $200,000 per year pay more than half (52 percent) of income taxes, but receive just 11 percent of the benefits from these plans. Source: "ASPPA Testifies in Defense of 401(k) System", September 15, 2011: *http://www.asppanews.org/2011/09/15/asppa-testifies-in-defense-of-401k-system.*

Underscoring the importance of payroll savings plans to low and moderate income workers, an analysis by the Employee Benefits Research Institute found that that more than 70 percent of workers with annual incomes of between $30,000 and $50,000 do save for retirement if they have access to a workplace plan. Yet fewer than 5 percent of their peers who lack access to a workplace plan save through IRAs. Absent access to workplace-based savings, then, most American workers simply fail to accumulate any serious savings with which to fund their retirements or supplements their Social Security benefits. Reducing the incentive for retirement plan sponsors to offer workplace savings plans, then, could force millions of low- and moderate-income workers to face retirement with little or no savings.

Cutting into tax advantages for retirement accounts would thus be far more than just a marginal revenue measure. It would mark a fundamental shift away from highly successful programs that Congress has supported for the past several decades. Doing so would risk irreparable harm to millions of future retirees and by reducing investment flows to the capital markets, might also limit future economic growth.

Without question, the skyrocketing Federal debt is a genuine threat to our long-term prosperity. But attempting to reduce Federal dis-saving by cutting incentives for personal savings is a bizarre and short-sighted approach. By definition, every dollars saved by individuals is one less dollar that they may need to ask for in public assistance in the future. The gain of a dollar in tax revenue today would be offset by the immediate loss of capital for investment in new business formation, job creation and economic growth. And it will be far offset tomorrow by the loss of investment gains in workers' retirement portfolios and by the risk that many of these less-well-off workers may need public assistance in their later years.

Policy changes that could diminish retirement security for future generations of workers and increase in poverty among elderly Americans, would betray the optimistic vision that has driven Americans for generations, and erode public confidence and personal dignity.

For all of these reasons, I urge all members of Congress to oppose any policy change that would undermine incentives for employers to offer workplace savings plans or for individuals to use them to save for their retirement.

My thanks to the Subcommittee for this chance to express my concerns. I request that my longer statement on this issue (Reflections on National and Personal Solvency) be included in the record as an addendum.

ADDENDUM

A world of investing.™

Putnam INVESTMENTS

June 2011 » Putnam perspectives

Reflections on National and Personal Solvency

Robert L. Reynolds
President and Chief Executive

Key takeaways

- Our country's pace of debt accumulation is both dangerous and unsustainable
- Substantial reforms must be made to entitlement programs before they drag down our economy
- We must transition to a new personal and government solvency based on higher savings and investment
- Private and public retirement savings programs both play key roles in the solution

As we can all see from this season's intense debates in Washington, finding a way to restore our national solvency is the single most critical issue for our future. But even as we strive for fiscal sanity for our government, we should recognize that personal solvency, grounded on strong household balance sheets and retirement savings, is equally vital. National solvency and personal solvency complement each other. They are both key to rebooting economic growth and sustaining America's future.

A dangerous, unsustainable course

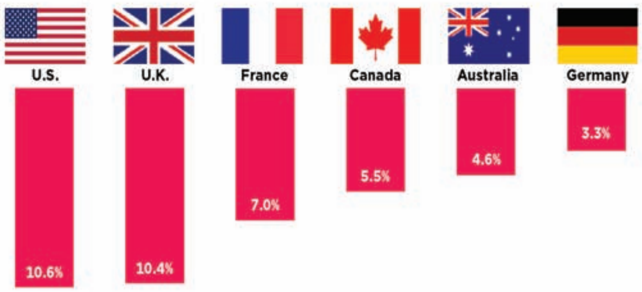
Our country is at a critical inflection point. We really do face a choice between decline and renewal. The budget debates we read about and see on TV are not media hype. The stark truth is that we're on a dangerous, unsustainable course — one that could wreck the America we inherited. Failure is not an option. Nor are inaction, denial, or delay. Federal deficits already claim a far larger share of our economy than that of such peers in today's global economy as the United Kingdom, France, Canada, Australia, and Germany.

National solvency and personal solvency complement each other. They are both key to rebooting economic growth and sustaining America's future.

Unless we change course, interest on our debt will quadruple by 2020 — reaching nearly $800 billion a year.

Figure 1. America's budget deficit is among the largest

2010 budget deficit as a percentage of GDP in some AAA-rated countries



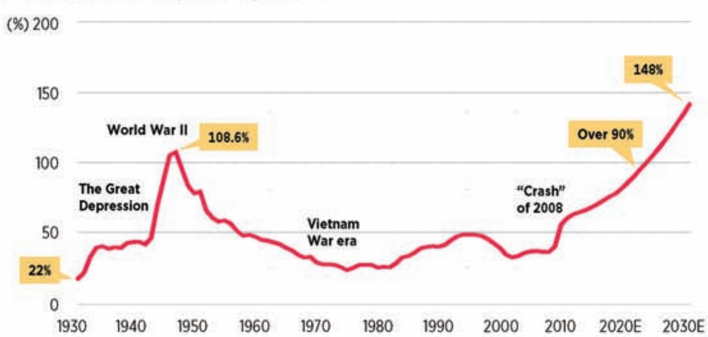
Source: International Monetary Fund. Note: IMF calculations for the U.S. differ from Congressional Budget Office figures, which put the U.S. deficit at 8.9% GDP.

Our $14.3 trillion national debt is mind-boggling, difficult to even imagine. If we measured it in $100 bills, that debt would create a stack 9,000 miles high! And yet our national leadership in Washington seems unable to engage in serious bargaining to deal with the issue. Amid partisan positioning over the terms of extending our national debt ceiling, concern for our country's credibility and solvency seems to be taking a back seat to the politics of the 2012 election. Meanwhile, the national debt is skyrocketing.

The Congressional Budget Office advises us that President Obama's recent budget would raise total national debt held by the public from roughly 63% of GDP today to more than 90% by 2020 with no end in sight! That is a debt-to economy ratio that America hasn't seen since World War II. And while this fiscal time bomb keeps ticking, interest costs on our debt are on track to explode.

Figure 2. Total national debt is on track to surpass GDP by 2020

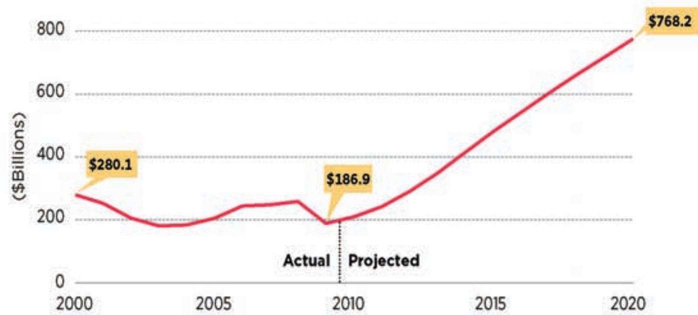
U.S. federal debt as a percentage of GDP



Sources: Heritage Foundation compilations of data from U.S. Department of the Treasury, Institute for the Measurement of Worth (Alternative Fiscal Scenario), Congressional Budget Office, and White House Office of Management and Budget.

Figure 3. Interest on the debt alone will reach nearly $800 billion annually

Inflation-adjusted dollars (2009)



Source: White House Office of Management and Budget, 2010 estimates.

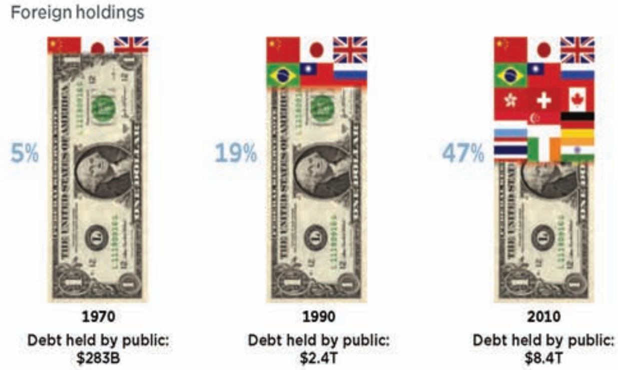
Unless we change course, interest on our debt will quadruple by 2020 — reaching nearly $800 billion a year. It is worth noting that this is happening at a time of historically low interest rates. That means that a sustained rise of just 1% in interest rates would add $150 billion more a year to this burden! Albert Einstein once described compound interest as "the most powerful force in the universe," and we are gambling against it!

What's worse, we now depend on foreign creditors to finance nearly half of our debt — 47% — nearly ten times as large as the 5% share they held in 1970!

So far, most of our foreign creditors still believe that America can — and will — get its fiscal act together. That is the only reason why the U.S. Treasury can still borrow huge sums of money 10 years out at roughly 3.5%.

Figure 4. Other countries hold nearly half of our debt today

Foreign holdings



Source: U.S. Department of Treasury.

America's dependence on foreign buyers at Treasury debt auctions makes us dangerously vulnerable to what former Presidential Chief of Staff Erskine Bowles has called "the most predictable financial crisis in history."

Unless we see substantial reforms to Social Security, Medicare, and Medicaid, these three entitlement programs alone will grow by 2045 to absorb as much of America's economy as the entire federal government budget has averaged since World War II.

But America's dependence on foreign buyers at Treasury debt auctions makes us dangerously vulnerable to what former Presidential Chief of Staff Erskine Bowles has called "the most predictable financial crisis in history."

Should global investors conclude that our political leaders are unable or unwilling to deal with our deficits and debt, we could be plunged into crisis by surprise virtually overnight. In a real sense, then, America doesn't actually have a choice about coming to grips with its debts and bringing government spending under control. The real choice we face is whether to act ourselves or be acted on by some very ruthless global markets.

That's why it is a healthy sign that both parties, including President Obama and Republican leaders of Congress, are at least talking about how to cut our deficits and control our debt. We should all hope that talk turns into action, preferably in the current Congress, while America still has some maneuvering room. Time is not on our side. Delay only makes the policy actions needed to curb debt more painful and the risk of crisis worse.

We must reform our entitlement programs

The key driver of our deficits is simple. America is aging. Life expectancy is rising. Baby boomers are turning age 65 at the rate of about 7,000 a day. And over the next 20 years, the number of Americans over age 65 will nearly double from 40 million to 72 million. That is more people than all but a handful of member nations in the United Nations.

The central impact of America's aging is this: Unless we see substantial reforms to Social Security, Medicare, and Medicaid, these three entitlement programs alone will grow by 2045 to absorb as much of America's economy as the entire federal government budget has averaged since World War II. So if we want government to pay for anything other than entitlements, whether that be the Marine Corps, Yellowstone Park, or the interest on our national debt, we will have to get serious about curbing entitlement costs and about raising some additional revenues to meet these demographically driven obligations. Both major political parties will have to make some painful concessions, which neither seems quite ready yet to do.

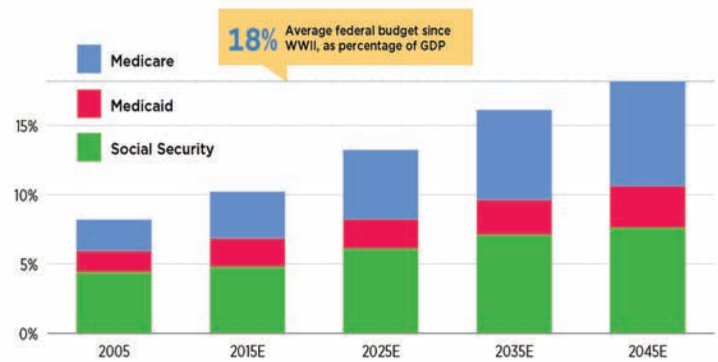
Figure 5. America is getting older

Americans over age 65

Source: U.S. Bureau of the Census, August 2008.

Figure 6. Entitlement programs are on track to reach 18% of GDP by 2045

Entitlements as percentage of GDP



Sources: GAO Sept. 2004 baseline extended analysis; Bruce Bartlett, Tax Reform Agenda for the 109th Congress 15 (2004). More recent data not available at the time of this presentation.

One thing that becomes very clear when you read the Standard & Poor's report that recently downgraded America's long-term debt prospects is that the real risk to our creditworthiness is not economic or financial. America has the economic resources to meet its obligations. The real risk is political paralysis, the seeming inability of our two-party system to find common ground, compromise, and make a transition that our country absolutely needs to make.

America's future economy simply has to be very different from the economic course we were on prior to the financial crisis of 2008–2009. We cannot go back to 2007 with a savings rate running near or below zero, debt-driven consumption as the economy's main driver, our homes turned into ATM machines, and leverage rising everywhere. We need to transition to a new economic model based on higher savings, more investment, more opportunity for entrepreneurship, and private sector job creation — a New Solvency, if you will.

In making that transition, action to strengthen America's public and private retirement systems can and will play a vital role in reviving confidence and sustaining growth in our economy. It is important to understand how our two-stroke retirement "engine" has evolved before we turn to ways of strengthening it.

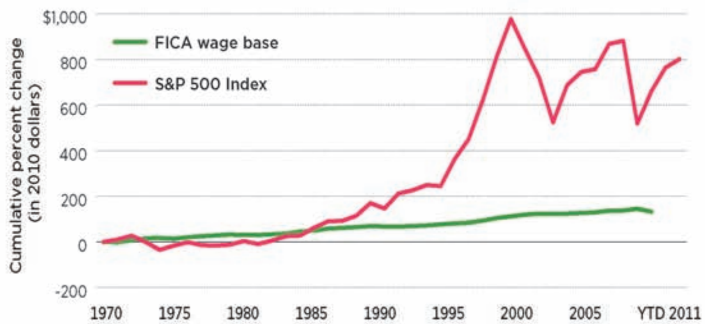
America's two-stroke retirement income engine

Retirement income in America is drawn from two quite different sources — human capital and financial capital. The main public retirement system, Social Security, is fueled by taxes on labor income (wages and salaries). Private retirement savings, mainly through workplace savings plans like the 401(k) or individual retirement accounts (IRAs), draw on financial earnings from profits, capital gains, dividends, and interest captured through stocks, bonds, and other investment securities.

We need to transition to a new economic model based on higher savings, more investment, more opportunity for entrepreneurship, and private sector job creation — a New Solvency.

Figure 7. Human capital and financial capital

Retirement income sources



Both the public and private retirement systems need strengthening. What's interesting to see illustrated here, though, is the way these systems complement each other. We use the FICA wage base to show the source of public retirement funds, i.e., from taxes on these wages, and use the S&P 500 Index as a proxy for long-term returns from U.S. equity markets.

The green line shows how the FICA wage base, which funds Social Security, has been rising slowly — but very steadily — for decades. Over the 40 years since 1970, it is up by about 130% in real terms, with only minimal downturns during recessions.

The red line shows the S&P 500 Index — also in percentage terms. It has risen vastly more since 1970 — by about 800% — but with vastly more volatility — including two ugly downturns in the past decade.

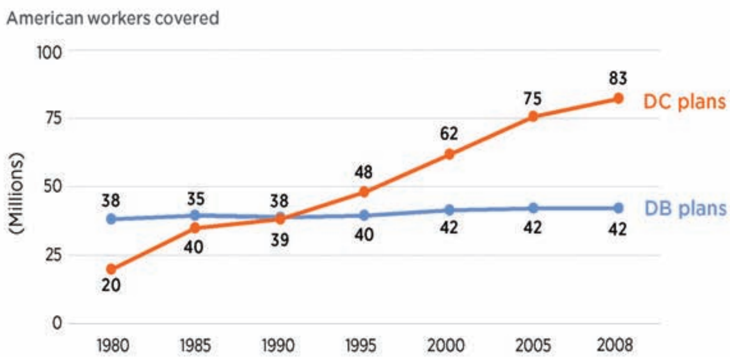
This suggests that the United States has actually diversified its sources of retirement income fairly well, linking flows from a steady, low-volatility source like wages to flows that come from faster-rising, but far more volatile, securities markets. To optimize results, we need to strengthen both sources. We must avoid over-burdening the workforce with any higher tax rates to support the public system — not a wise policy when our highest priority has to be job creation. Yet we also need to increase revenues flowing into the system, most likely by raising the cap on the percentage of salaries subject to the FICA tax.

On the private side, we must better enable all American workers to efficiently capture potentially high returns from securities markets while mitigating the risks we see here from frequently high volatility. This suggests the need to both extend coverage, through vehicles like auto-IRA payroll deduction, and build better ways of controlling volatility and reducing "sequence-of-returns risk" into workplace savings plan designs.

Recent research shows that workers in their 20s and 30s whose employers fully implement auto-pilot plan designs will be able to replace between 40% and 60% of their preretirement incomes just from their DC plans!

Congress's budget rules allow only a 10-year "window" to analyze the impact of tax deferrals. That methodology seriously overstates the costs to Treasury of savings tax deferrals and takes no account of future flow-backs when these assets are drawn on by retirees.

Figure 8. Today, America saves in workplace plans



Sources: Private Pension Plan Bulletin, Abstract of 2008 Form 5500 Reports, U.S. Department of Labor, December 2010. Collective Bargaining Status of Pension Plans, Total Participants by Type of Plan.

We have a strong savings base to build on

The good news is that we have created a robust private workplace savings system, based mainly on 401(k) savings plans. These defined contribution (DC) plans now reach more than 83 million workers. And the DC system has proven itself to be strong, resilient, and always open to improvement. We also still have over 40 million people who enjoy defined benefit (DB) coverage, though that number is flat or falling except in the public sector.

This suggests to me that if we can strengthen the DC system and extend its reach, we can take huge strides toward shoring up Americans' belief in their own futures. And there is every reason to believe we can because the defined contribution 401(k) system has always been dynamic, not static. And with the passage of the Pension Protection Act of 2006, we transformed that system qualitatively, enabling 401(k) workplace savings to become America's primary retirement system.

The PPA endorsed three game-changing elements of defined contribution savings plan design: auto-enrollment, savings escalation, and guidance to wise asset allocation — mainly age-appropriate lifecycle funds and balanced funds. The law also gave plan sponsors who adopted these best practices strong "safe harbor" legal protection.

Today, the evidence on these policy innovations is in, and the good news is that we have essentially solved the challenge of accumulation. We have not fully implemented the solution. But we do know what works.

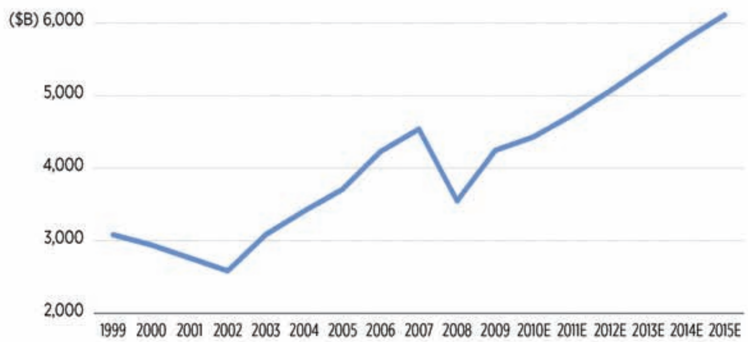
Recent research shows that workers in their 20s and 30s whose employers fully implement auto-pilot plan designs will be able to replace between 40% and 60% of their preretirement incomes just from their DC plans! That is before you count Social Security, other savings, home equity, life insurance holdings, or any other assets they may have. In short, the best of today's post-PPA, auto-pilot workplace savings plans really do get the accumulation job done.

So despite the awful impact of the 2008–2009 market crash, which slashed total workplace savings by nearly $1 trillion, the DC system is being revitalized. Most partic-

Whatever we do to curb federal deficits, we should never cut into incentives for personal or workplace savings. It would be a truly grotesque policy mistake to try to curb public deficits by undercutting tax deferrals for private savings.

Figure 9. Defined contribution plans have demonstrated resiliency

Projected DC assets 1999–2015



Source: FRC Monitor, September 2010.

ipants' account balances have rebounded very strongly, and workplace savings are projected to grow by nearly 70%, to over $6 trillion, just in the next five years.

Curbing savings plans is the wrong way to curb deficits

Yet as all of us involved in retirement savings policy know, a terribly ironic new threat has cropped up. Precisely at the moment when we have finally figured out how to design workplace savings plans that can build up reliable lifetime nest eggs, just as we are recovering from the painful crash of 2008–9, we now face a new potential risk — aimed right at the heart of retirement savings.

It stems from well-intentioned, but misguided efforts to cut federal deficits. To understand this risk, you need to see savings tax deferrals through a very bizarre lens, the one used by all too many "budget hawks" in Washington. Rightly concerned to curb deficits, these policymakers wrongly view the temporary tax forgiveness that retirement savers get for putting funds in an IRA, a 401(k), or variable annuities as "tax expenditures." They forget that these assets will be taxed (and as ordinary income) the minute they are drawn on by retirees.

This misreading is made possible because Congress's budget rules allow only a 10-year "window" to analyze the impact of tax deferrals. That methodology seriously overstates the costs to Treasury of savings tax deferrals and takes no account of future flow-backs when these assets are drawn on by retirees. A recent study conducted for the well-respected American Society of Pension Professionals and Actuaries (ASPPA) suggested

Capping or eliminating incentives for workplace and other retirement savings could have a devastating impact — sending millions of low-and moderate-income workers toward retirement with essentially no savings. This is exactly the wrong direction for our country to consider moving in.

that this 10-year forward "window" for assessing savings deferrals' "costs" to Treasury may overstate their true lifetime impact by between 55% and 77%. Making matters worse, budget hawks also have no way to take account of any dynamic benefits that savings may bring, through lower capital costs, for example.

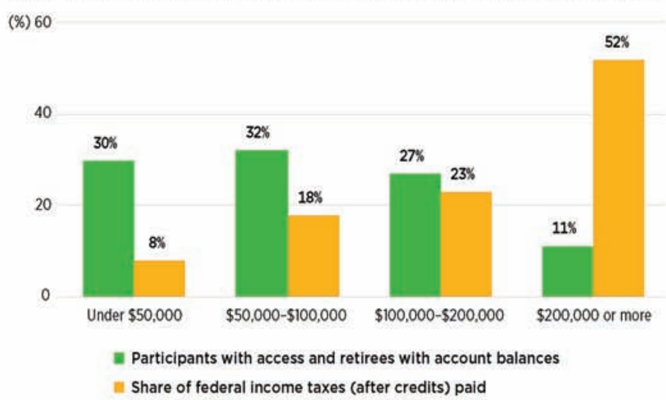
It is not surprising, then, that both of the recent deficit commissions proposed caps on the maximum amount of savings deferrals they would allow. One of the commissions proposed initially to sweep away all savings incentives, before backing off to suggest a cap of $20,000 a year or 20% of salary, whichever is lower. Such a limit may not seem very menacing. But once savings tax deferrals are on the table, then they are in play. The temptation to cut deeply into them is great. And that is exactly what happened in the last major tax code overhaul in 1986, when ceilings for 401(k) contributions were severely slashed and so many complications were imposed on IRAs that their growth was stymied for years.

We do, of course, absolutely need to get deficits under control. But whatever we do to curb federal deficits, we should never cut into incentives for personal or workplace savings. It would be a truly grotesque policy mistake to try to curb public deficits by undercutting tax deferrals for private savings by individuals and families to secure their own futures. After all, every dollar that retirement savers set aside is one less dollar that will ever be asked for as government aid in the future. Every company that offers a workplace savings plan is helping to meet a real national need. And the incentives for workplace savings do encourage employers, especially small businesses, to offer savings plans to low- and moderate-income workers — not just to the owners and their key executives.

Figure 10 shows the distribution of the tax deferrals for workplace savings — by income level — as well as the percentage of income taxes paid by individuals with those earnings. As you can see, 62% of these tax deferrals go to people earning less than $100,000 and 38% to those earning more than $100,000.

But let's compare these tax deferrals to the federal taxes people actually pay. When we do that, we see that workers earnings less than $100,000 pay just 26% of federal income taxes but receive more than twice as large a share of tax deferrals — 62% — than the share of income taxes they actually pay. And while 38% of the tax deferrals go to those earning more than $100,000, these people pay fully three quarters of all federal income taxes. In other words, more affluent earners get only

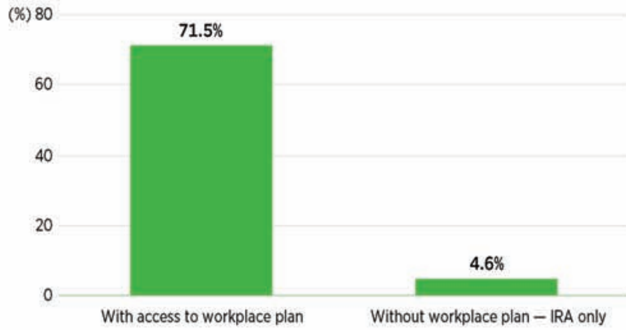
Figure 10. The benefits of workplace plans accrue disproportionately to those who need them



Source: American Society of Pension Professionals and Actuaries, 2011.

We need bipartisan action and compromise to deal with this — and that is going to take guts.

Figure 11. People with access to workplace plans do save



Source: Employee Benefit Research Institute (2010) estimate using 2008 Panel of SIPP (covered by an employer plan) and EBRI estimate (not covered by an employer plan — IRA only).

about half the share of savings tax breaks as they pay in taxes.

A fair conclusion seems to me to be that the potential revenue gains to the Treasury from cutting tax deferrals is vastly overstated. But the damage such caps could inflict is vastly underestimated. That is because access to workplace savings is the prime determinant of whether low- and moderate-income workers save — at all. Over 71% of workers earning between $30,000 and $50,000 do save for retirement, but only if they have access to payroll deduction savings plans at work. Among moderate-income workers who lack access to savings at work, fewer than 5% open tax-advantaged individual retirement accounts.

This suggests that capping or eliminating incentives for workplace and other retirement savings could have a devastating impact — sending millions of low- and moderate-income workers toward retirement with essentially no savings. This is exactly the wrong direction for our country to move in. Instead of cutting savings incentives, we should be doing everything we can to expand workplace savings coverage for the many millions who lack it. One excellent way to do this would be the adoption of the auto-IRA payroll deduction proposal, a very reasonable, cost-effective idea that could draw many millions of lower-income workers into retirement savings and give them a stake in our free-enterprise system for the first time ever.

The auto-IRA is a bipartisan idea developed jointly by the Heritage Foundation and the Brookings Institution. It links values that I believe should guide our policy choices in coming years, namely that national solvency and personal solvency go hand in hand. They complement each other. We should never pit one against the other. We need policies that foster both.

Real action to make Social Security solvent would be a huge confidence builder at home and around the world, proof positive that Americans can control our own destiny.

There really can be no doubt that the best way, the most American way to deal with our deficits and restore national solvency, is to fire up America's job machine and get our economy growing faster than our debts.

Working toward a new solvency

As we strive to restore fiscal sanity, the vital first step has to be recognizing that our deficits and debt are now dangerous enough to pose a genuine national security threat. We need bipartisan action and compromise to deal with this, and that is going to take guts, whether that be Democrats backing changes that slow the rise in entitlements, Republicans recognizing that we surely will need more tax revenues as the boomers age, or members of both parties coming together to create a pro-growth, pro-investment tax code.

Those politicians and special interests who refuse to admit that we even face a serious fiscal problem or who say we don't need to make any serious changes in Social Security or Medicare are simply in denial. If their view wins, they will set America adrift, blindly, straight into a globally driven debt crisis and then into truly awful austerity, under ruthless market pressure, just as we are seeing happen in Greece.

There are many elected officials and policymakers who are seeking good-faith, bipartisan solutions to curb federal spending and bring our deficits under control. In my view, these men and women are actually the truest defenders of the common safety net, the real leaders, pointing America's way to fiscal stability and a shot at renewed prosperity. We can find them in both political parties. And we need a lot more of them!

The single best first step we could take would be to reach a "grand bargain" to bring Social Security into long-term solvency. We can — and should — preserve the essence of Social Security and protect the truly needy. Social Security is a cornerstone element of most Americans' retirement. It is absolutely vital to lower-income citizens who draw the vast majority of their retirement income from it. But the system is running a cash-flow deficit of nearly $50 billion this year, and it faces a multitrillion-dollar long-term funding shortfall over the 75-year time frame its trustees are required to plan for. We need action to make it solvent, and the only better time to do that was yesterday!

A viable Social Security deal would almost surely require Republicans to compromise on some measures to increase revenue. Democrats would have to concede that benefit increases will need to be slowed — or means tested. It is important to note that what we are talking about here is a self-inflicted "gap" between the benefits that Congress has promised future retirees and the revenues it has voted for to pay for those promises. Closing this gap is really Congress's responsibility. With strong presidential leadership, that would be an eminently doable goal.

I say that because it is an open secret in Washington that matching Social Security's revenues to promised outflows for the next 70-plus years may be the easiest single element of America's much larger solvency challenge. It requires arithmetic, not rocket science. It is infinitely easier than grappling with our medical entitlements, which face long-term shortfalls roughly 10 times larger.

To be politically feasible, Social Security reform needs to meet three key criteria. First, we should not impact the benefits of any current retirees or those within 10 years of full retirement age. Second, we should not raise the basic payroll tax rate. That would discourage job creation just when we need it most. Third, we should sustain intact all future retirement benefits for low-income Americans. All other paths to solvency should be open to discussion, including retirement ages, the percentage of income subject to FICA taxation, and benefits paid to middle-class and wealthy retirees — whatever it takes.

We actually know that these criteria can be met, because both of the recent budget commissions essentially did meet all three of them. It is true that the plans these commissions put forward would require some sacrifice by middle-class and wealthy recipients, but these sacrifices would mostly come in the form of smaller increases in some future benefits, not absolute cuts. It would even be possible, in fact, to not only secure, but actually increase benefits for the lowest-income retirees as part of a reform package.

In other words, it is possible to craft a reform plan that would not only make Social Security solvent, but slightly more progressive, slightly more redistributive, and vastly more certain than the current system. Social Security solvency does not require draconian measures, just common sense and some very uncommon political courage — in other words, leadership.

Real action to make Social Security solvent would be a huge confidence builder at home and around the world, proof positive that Americans can control their own destiny. It would have major, positive benefits for the dollar, for national confidence, and perhaps even for mutual trust across our partisan divides.

We should link a solvent Social Security system to reforms that strengthen and extend private workplace savings to reach virtually all working Americans, including the payroll deduction auto-IRA I mentioned earlier.

Personal solvency, defined by solid savings rates, and a revitalized, expanded workplace savings system can help fuel stronger economic growth — the single most vital element in any plan to reduce our future deficits.

President John F. Kennedy was right when he said that "a rising tide lifts all boats." And policies to foster investment and business formation follow directly, even inevitably, on efforts to raise national savings. Why? Because we need to give these additional savings positive options for investing in America's future. There really can be no doubt that the best way, the most American way to deal with our deficits and restore national solvency, is to fire up America's job machine and get our economy growing faster than our debts.

Like JFK, I am an optimist. You really have to be if you are lucky enough to live in this country. People risk their lives every day to come here. And they are right to want to. So as scary as our deficits are, as huge as our national debt may be, I know this for sure: America has dealt with much, much tougher challenges before.

I am convinced we can meet this one. All we need is the will.

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Based on remarks to the Greater Boston Chamber of Commerce Executive Forum, Boston, Massachusetts, May 24, 2011.